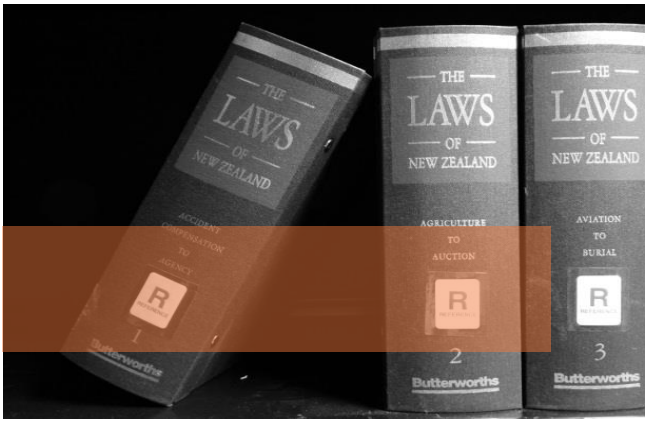

Insurance Case Law Update

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June 2015

In this update, we summarise significant decisions released in the first half of 2015.

It has been a busy June, with various substantive judgments released by the High Court and Court of Appeal. Judgments given on preliminary questions are now being tested against findings of fact. The decision of Kós J in *Jarden v Lumley General Insurance (NZ) Ltd* highlights the importance of factual evidence and the evidential standards that must be met: "Tea leaves are no substitute for testimony".

A more extensive discussion of particular judgments is linked to the case names highlighted in the summary table. For further information on issues raised in this update, please contact the Hesketh Henry insurance law team.

Summary of cases:

Case	Issues	Decision / Principle
Quake Outcasts v Minister for CER [2015] NZSC 27	**Lawfulness of Crown offers** to purchase uninsured and vacant red zone land	Decision to offer to purchase uninsured and vacant land for 50% of its 2007 rateable value was not lawfully made and requires reconsideration. Crown should not have used its prerogative to create the red zone, but declaration would serve no purpose.
New Zealand Fire Service Commission v Insurance Brokers Association of New Zealand Inc [2015] NZSC 59	**Calculation of fire service levies** under Fire Service Act 1975	SC overturned the long standing practice of calculating fire service levies on the indemnity value nominated in the insurance policy, rather than the actual indemnity value. A composite policy held by eight companies was, on its terms, to be treated as eight contracts, each with a separate indemnity sum on which the levy is payable. NZFSC agreed the SC's ruling should not have retroactive effect.
Vero Insurance New Zealand Ltd v Morrison (CA)	Assessment of **damage in multiple earthquake events**	Consideration of the weight to be given to computer modelling evidence when attributing damage to a particular earthquake event.
Medical Assurance Society of NZ Ltd v East (CA)	**Payment of repair costs** Meaning of **"as new"**	If insured elected to restore, insurer's obligation was to meet actual costs as they were incurred. "As new" means in accordance with current building consent requirements.
Kraal v EQC [2015] NZCA 13, [2015] 2 NZLR 589, [2015] 18 ANZ Insurance Cases 62-055	Whether **loss of a right to occupy** due to a risk of future damage is "physical loss or damage to the property"	"Red Zone" property owners unable to occupy home because of risk of rock falls from neighbouring land, claimed loss of possession and use constituted "natural disaster damage" under the EQC Act and "damage" under a private insurance policy. CA upheld HC judgment that physical damage to the land or buildings is required.

Case	Issues	Decision / Principle
		Deprivation of use does not qualify. Not a test case by EQC: costs follow the event.
EQC v Whiting [2015] NZCA 144	**Costs** on discontinuance	If a defendant pays a claim following the issue of proceedings, and the plaintiff discontinues the proceeding, the Court may – at its discretion – award costs to the plaintiff.
Body Corporate 326421 v Auckland Council (HC)	**Leaky buildings**: response of PI policy to claims with multiple causes	Claim against main contractor for design and construction defects in the Nautilus apartment tower. Defects caused by both design and construction errors: cover excluded.
Domenico Trustee Ltd v Tower Insurance Ltd (HC)	Insurer's right of **election**	Insurer did not elect whether to reinstate or make a payment while negotiations and proceedings were underway. Delay was not reasonable; law imposed an election to pay the indemnity value subject to any increase for rebuilding costs actually incurred.
Prattley Enterprises Ltd v Vero Insurance New Zealand Ltd (HC)	Assessment of **damage in multiple earthquake events** Whether **settlement based on a misunderstanding** can be set aside	Measure of loss under an indemnity policy is the market value of the building, if the insured does not intend to reinstate the building. No basis to set aside a full and final settlement in circumstances where the insured received independent advice and the insurer acted transparently and in good faith.
Body Corporate 346930 v Argon Construction Ltd [2015] NZHC 129	**Leaky buildings**: liability of Building Industry Authority for regulation of building certifiers	BIA does not owe a duty of care in tort to investigate whether a building certifier is acting within the certifier's scope of authority in circumstances where there is cause to query the certifier's conduct. BIA may owe a duty to keep the register of building certifiers up to date.
Houghton v Saunders [2015] NZHC 548	Litigation funders and **costs**	The involvement of litigation funders does not in itself give rise to a right to indemnity costs. Funders jointly and severally liable for a costs order against the funded party. A contractual cap on costs in the funding agreement was held to limit the funder's liability to other parties for their costs.
McCullagh v Underwriters Severally [2015] NZHC 1384	**Extra territorial reach of s 9** of the Law Reform Act 1936	Amounts payable by overseas-based underwriters under policies of insurance are not subject to a charge under s 9. Charge does not descend when payment is made to an insured within NZ.
AAI Ltd v 92 Lichfield St (in rec and liq) [2015] NZHC 1421	Whether a **settlement offer** was "subject to contract"	Offer included a statement that if the settlement was acceptable, a form of discharge would be sent for the appropriate sum. A dispute arose as to the appropriate sum and the discharge terms. Parties intended to be bound when the offer was accepted; contract was not dependent on execution of the discharge. Insured entitled to issue statutory demand for the settlement sum.
Jarden v Lumley General Insurance (NZ) Ltd [2015] NZHC 1427	**Causation** and **proof**	House with pre-existing construction defects was damaged in two earthquake events. Plaintiff has burden of proving cause of damage on the balance of probabilities.

Vero Insurance New Zealand Ltd v Morrison [2015] NZCA 246

Morrison v Vero grappled with the issue of how to apportion damage between multiple insured earthquake events. This appeal largely concerned Vero's challenge to the admissibility of, and weight given by the High Court to, computer modelling used by the respondents' expert.[1]

Vero's appeal required the Court to consider whether the judge was right to:

1. prefer the respondents' expert modelling evidence concerning the additional damage caused by the June 2011 earthquake and the respondents' scope of repairs for the June 2011 earthquake over that of Vero's experts;

2. conclude the building was not "destroyed" as a result of the February 2011 earthquake.

The modelling evidence and the June 2011 earthquake

Vero challenged Whata J's decision that modelling evidence could be used as an input to determine the extent of relative damage between the earthquakes. However, the Court of Appeal considered the evidence was "plainly relevant", that it met the reliability threshold and had some probative value. The Court instead focused on the weight given to the model by the judge, having regard to the paucity of other available information, the limitations inherent in the model itself, and the support given by one of Vero's experts to the model (at least at a conceptual level).

The Court of Appeal accepted Vero's submission that the failure of the model to take account of the effects of liquefaction in February 2011 cast doubt on the weight to be given to it. Upholding Vero's criticism of the relative assessment of damage between the earthquakes, it concluded that there was no explanation for how the percentage figure adopted by the respondents' expert for the June 2011 earthquake translated into his list of repairs (noting that some items on the list of repairs were already being replaced after the February 2011 earthquake). These factors led the Court to conclude that the model was given substantially more weight than it should have been.

The Court then considered whether the model, when viewed in conjunction with a photographic essay prepared by the respondents' expert, supported the judge's conclusion on the scope of additional repairs required after the June 2011 earthquake. Vero's evidence was that the June earthquake did not cause any significant new damage and, most critically, any further damage did not alter the scope of repairs to any degree of materiality. The Court found that the judge was right to acknowledge that there were limitations in the photographic essay, but that he was also right to have regard to it in light of all the other evidence and conclude there was some discernible additional damage to the building.

Accordingly, the Court found some addition to the scope of repairs was needed after the June 2011 event, although costs were likely to be relatively minor. Rather than set a nominal figure, it referred the issue back to the High Court. The Court expressed optimism that the parties might be able to reach agreement on this issue.

Was the building destroyed?

The Court considered the effect of the relevant policy provisions and the principles set out in *Wild South*[2]. It noted Vero relied upon economic and practical considerations to support its claim that the building was destroyed after the February 2011 earthquake. However, the Court noted that the building was still functional and placed weight on evidence that as at December 2012 the estimated rebuild cost was approximately $9m and the repair cost about $7.1m. The policy wording did not support an interpretation of destruction based on economic considerations and the Court accordingly upheld the Judge's finding that the building was not destroyed.

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[1] For our summary of the High Court judgment, click here.
[2] *QBE Insurance (International) Ltd v Wild South Holdings Ltd* [2014] NZCA 447, click here for our review of the decision

Cross-Appeal: calculation in relation to the September 2010 earthquake and cost of new piling

The Court of Appeal dismissed the respondents' cross-appeal concerning the calculation of damage caused by the September 2010 earthquake and whether the cost of new piling should be excluded. It noted that there was considerable expert evidence against liquefaction-induced damage having occurred in the September earthquake. Further, it agreed with Whata J's analysis on the relevant principles of indemnity and policy wording and accepted Vero's submission that the indemnity payment is founded on a depreciated estimated cost to put the building back to its "pre-earthquake, no piles" condition.

Concluding comments

This decision confirms that modelling evidence will be admissible where it is relevant and has some probative value. What weight it will be given may depend on the other available evidence, and consideration of the limitations inherent in the model.

A similar model was considered by the High Court in the recent decision of *Prattley v Vero* (click here for our summary). In that case, there was considerable eyewitness and photographic evidence of the building's condition from inspections which followed each earthquake event. Dunningham J noted that *"the allocation of damage which the model arrives at as between the three earthquake events is so at odds with the observed damage that I do not think it is a reliable tool to calculate what in fact needed repair after each event."*

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Medical Assurance Society of NZ Ltd v East [2015] NZCA 250

The Court of Appeal has partly overturned one of the more unexpected decisions from the High Court Earthquake List.[3] The appeal judgment considers: when the obligation to pay rebuilding costs is incurred; the meaning of "as new"; and the interplay between the policy terms and local authorities in relation to compliant repair methods.

Background

The Easts own a two-storey house built in 2007 with a concrete slab floor and a timber frame on flat land. The house suffered damage from the Canterbury earthquakes.

Under their policy with MAS, the Easts had the option to either: (1) restore their house, in which case MAS would cover reasonable costs of this on a replacement value basis; or (2) take a cash settlement on an indemnity value basis. If the Easts elected restoration, the relevant policy provision said:

> "*[MAS] will cover the cost of rebuilding or restoring the dwelling to a condition substantially the same as new*, so far as modern materials allow, and including any additional costs which may be necessary to comply with any statutory requirements or Territorial Authority by-laws. There is no maximum sum insured but *the liability of the Society shall not be greater than the reasonable cost to rebuild or restore the dwelling* …" [Emphasis added]

The Easts elected to restore their house, and then sought payment up-front from MAS of the estimated costs of this (rather than have MAS pay the actual costs as they were incurred). The Easts also claimed that underpinning was required in order to restore the house to an "as new" condition, which MAS disputed in favour of a low mobility grout (LMG) method.

Payment of repair costs

In the High Court Whata J had determined that MAS was obliged to pay the Easts the estimated cost of repairing the earthquake damage irrespective of whether liability to incur those costs had been or would ever be incurred. This was rightly overturned on appeal.

The Court of Appeal held that, if the insured has elected to restore the property, MAS is only obliged to meet the actual restoration costs as they are incurred. This was consistent with the phrase "will cover", which is shorthand for "indemnify the insured against".

In allowing this part of the appeal, the Court returned to orthodox insurance obligations and practices regarding reinstatement cover, which reflect the fact that construction costs are paid incrementally up until completion. The Court also recognised that an up-front payment on a replacement basis would be tantamount to a cash settlement; yet the policy expressly contemplated that a cash settlement would only be paid on an indemnity basis if the homeowner did not elect to restore the house.

Concerns about the mechanics of an insured seeking payment from their insurer and the "fetter" this might place on the prima facie right to replacement value compensation, did not carry weight in the Court of Appeal. An insurer's failure to indemnify actual restoration costs without proper justification would carry "serious legal and reputational costs", there were no reported cases of this ever occurring, and the absence of any prescribed mechanism in the policy itself was irrelevant.

At the same time, the policy did not provide any mechanism for the insured to account to MAS for any surplus (if the payment was based on an over-estimate) and the High Court decision arguably would have left MAS without any contractual right to recover any surplus. Further, it would be difficult to prevent the insured from applying the funds to some other purpose or establishing that the claim had been made with a fraudulent intent.

This decision supports a long-standing approach to indemnifying restoration costs and it is likely to have wider application to other policies. Notwithstanding this, in order to put the matter beyond doubt,

[3] *East v Medical Assurance Society* [2014] NZHC 3399

insurers should consider whether their policy wordings need revision to make it clear that restoration costs will not be paid until the costs are actually incurred.

"As New" / Building Code

The Court of Appeal upheld that "as new" meant restoring the Easts' house in accordance with current building consent requirements, rather than those that existed in 2007 when the house was built. This was the ordinary meaning of the words "as new" and was supported by the reference in the policy wording to compliance with statutory and local requirements.

The standard of repair became relevant after the Easts claimed underpinning was necessary due to the particular ground conditions. MAS believed this to be "super conservative" and thought the house could instead be re-levelled using LMG or a similar method to the 2007 code requirements.

In the High Court, Whata J concluded that underpinning was necessary in order to meet the current Building Code, but recognised that the Council might reach a different view and approve LMG when granting building consent. In view of this, leave was reserved to determine quantum issues if that outcome eventuated. That reservation was unsuccessfully challenged by the Easts in a cross-appeal. The Court of Appeal said:[4]

> "[Whata J] was simply meeting the contingency that, despite his own findings about the appropriate engineering solution, the Council may nevertheless approve the solution favoured by MAS. As the consenting authority, the Council has the ultimate word on this issue. It was appropriate for the Judge to reserve leave to settle quantum if the Easts' claim ultimately fell for measure on a different basis from that proposed".

Quantum – exaggerated claims

During the trial the plaintiffs' QS conceded "significant errors" in his estimate, which resulted in a grossly exaggerated claim. This did not go unnoticed by the Court of Appeal. Considerable indulgence was granted to the plaintiffs' QS to reconsider his costing, and with leave reserved to determine quantum if necessary.

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[4] Local authority building consent decisions may be re-heard by way of Ministry Determination.

Body Corporate 326421 v Auckland Council [2015] NZHC 862

This was a substantial claim for construction and design defects in a 12 floor apartment building called the Nautilus. The unit owners and Body Corporate sued the Council, the head contractor, the architect, the cladding subcontractor and the tiler. They were largely successful, and were awarded $25.07 million in total. However, most of the defendants were insolvent: only the Council and the tiler (whose liability was limited to certain defects) remained.

The head contractor was Brookfield Multiplex Constructions (NZ) Ltd (in liquidation) (**BMX**). It was found liable for all of the defects. A question arose as to whether a professional indemnity policy held by BMX, under which Zurich Insurance plc was the lead underwriter, would respond to the claim.

Under the policy, BMX was covered for contractual or other claims arising out of negligent performance of "Professional Activities and Duties". That cover extended to any negligent acts of consultants prior to novation of the consultancy agreement to BMX. "Professional Activities and Duties" meant activities undertaken by, or under the supervision of professionally qualified persons of at least five years relevant experience, but excluded day-to-day supervision of construction work. The policy also excluded claims arising out of defective workmanship or materials, unless the claim related to the negligent design of materials or the negligent specification or selection of materials.

Although the consultancy agreement between the developer and the architect had been novated to BMX, the terms of the novation excluded liability for the design of the Nautilus, other than for minor errors and omissions which an experienced contractor would be expected to foresee, or design changes introduced for BMX's benefit.

BMX had the onus of establishing that every defect for which indemnity was sought came within the insuring clause, including the "Professional Activities and Duties" definition. The underwriters had the onus of proving that the exclusion then applied to exclude BMX's claim in relation to each defect.

The Court held that if a claim had multiple causes, it would be covered if *one* of the causes fell within the insuring clause, provided *none* of the causes fell within the exclusion for defective workmanship or materials. A "cause" need not be the proximate cause, it could be simply a material contributing factor. If defective workmanship was a material contributing factor to any particular defect, the claim in relation to that defect would be excluded.

The Court examined each cause of action set out in the statement of claim. The plaintiffs' claim against BMX for breach of the head contract (which was assigned to the plaintiffs by the developer) was for failure to correct defective workmanship and materials in the defects liability period. There was no allegation of defective design, and the insuring clause was not activated.

The plaintiffs' claim in negligence was for a breach of a duty of care "relating to design and construction issues". Those issues included modifying the design of the cladding system, construction of the Nautilus with the defects and failing to rectify the defects during the defects liability period. The underwriters claimed that defective workmanship was a material contributing cause in respect of all such losses. A review of each of the defects and their proven causes indicated that poor or defective workmanship was indeed a material cause of each head of loss. As a result, the policy did not respond to any part of the plaintiffs' claim.

This case demonstrates the limitations of professional indemnity policies for head contractors, and a potential exposure for principals if the contractual design risk is shifted from the design consultant to the head contractor. While BMX only assumed a limited design risk under the terms of its novation, had the complete risk in fact been transferred, the exclusion in the policy would have applied to all claims for defective design.

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Domenico Trustee Ltd v Tower Insurance Ltd [2015] NZHC 981

This case concerns an insurer's right of election.

Summary

Tower could choose to settle the insured's claim for earthquake damage by reinstatement or payment. It did not make an election while negotiations and proceedings were underway and the delay was unreasonable. As a result, the Court effectively substituted its own election – to settle the claim by cash payment of the indemnity value of the property, to be topped-up if actual rebuild costs were higher.

Canvassing an insured about the method for settling their claim is laudable. However, where insurers have the choice, they should carefully consider making an election once genuine deadlock is reached, such as when proceedings are issued by the insured.

Background

Domenico owned a residential property, which was damaged beyond economic repair in the Canterbury earthquakes. The house was insured by Tower.

Under the policy, Tower could settle the claim by reinstatement or payment. If reinstatement was chosen, Tower would meet the "full replacement value" (ie the costs actually incurred to rebuild the house). If payment was chosen, Tower would pay the "present day value" (ie the indemnity value of the property).

Even though the method of settling the claim rested with Tower, it sought input from the Domenico regarding the preferred settlement option. Domenico desired a cash settlement but wanted to be paid the value of a rebuild without actually incurring rebuild costs. This was, strictly speaking, outside the policy terms. Nevertheless, discussions and negotiations proceeded on this basis. Offers were made for a cash settlement (in the region of $240,000-$270,000 gross of EQC payment) and at one point the parties got close, before Domenico issued proceedings in April 2013 claiming $842,392.

The proceeding considered: (1) whether Tower had the right to reinstate instead of paying cash; and (2) whether Tower had made a binding election to pay the rebuild costs in cash without requiring the insured actually to incur replacement costs.

Election to settle the claim

The judgment contains a helpful and comprehensive discussion about the doctrine of election in an insurance context. After surveying the authorities, Gendall J concluded:

a) Tower plainly had the right to reinstate instead of paying cash, and the choice between those options rested with it;

b) An election must be unequivocal, unqualified and communicated to the other party;

c) Tower was obliged to elect the method of settlement within a reasonable time;

d) Tower stood ready and willing to settle the claim, but had not, by words or conduct, made an unequivocal election to make a payment or to reinstate;

e) The reasonable time for making an election had passed. By April 2013, 3½ years after the first earthquake, Tower had all of the material facts to settle the claim and the only impediment was the deadlock between the parties. Met with a statement of claim seeking more than treble its latest settlement offer, Tower should have realised amicable settlement was unlikely and made an election.

In the circumstances, Gendall J gave judgment that Tower was liable to pay the indemnity value of the property but, if Domenico chose to rebuild or buy another house, Tower would be obliged to meet any

increase in cost in accordance with the policy terms. In reaching this finding, which had not been specifically sought by either party, Gendall J said: *"I … consider, by a reasonably fine margin, as a result of effluxion of time, Tower has made an election to settle [the claim on this basis]"*. Payment of the indemnity value does not appear to have been a default choice under the policy. Therefore, it seems that the Court effectively substituted its own election, which could be considered a novel approach to the doctrine of election.

This was, nevertheless, a pragmatic outcome that gave a baseline sum with the opportunity for top-up if Domenico did actually re-build the house. As there was no evidence on the indemnity value (the sums sought/offered had been based on the estimated re-build costs), Gendall J was unable to determine quantum. And with *"no true victor"*, costs were reserved.

Exaggerated claims

Exaggerated claims have, regrettably, become commonplace in the earthquake list, and this is yet another example. Domenico initially claimed $842,392, which slowly retreated before settling on a figure of $370,000 for the purposes of trial. Gendall J observed that it was *"remarkable, in a rising building market that final costs amount to only around 44 per cent of the quantum initially claimed"*. Tower was less restrained in describing Domenico's first estimates as "outrageous" and "extravagantly inflated". It remains to be seen whether this impacts costs as it has in other earthquake cases.

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Prattley Enterprises Ltd v Vero Insurance New Zealand Ltd [2015] NZHC 1444

This is one of a series of cases dealing with the issue of incremental damage in successive earthquake events, which includes *Ridgecrest*[5] and *Wild South*[6]. It has however an important twist: the plaintiff had already settled its insurance claim based on the market value of the building. The plaintiff alleged it had misunderstood its rights under the policy, and sought to the have the settlement set aside.

The plaintiff's claim, based on the Supreme Court decision in *Ridgecrest*, was that it was entitled under its policy to claim reinstatement for damage caused in each earthquake, plus the depreciated replacement cost of the building following its destruction in the final earthquake.

Dunningham J disagreed. While the plaintiff had an event-based policy, it was an indemnity policy with a different measure of loss to the full replacement policy at issue in *Ridgecrest*. Under the policy terms, the insurer could elect to indemnify the insured either by making a payment, or by repairs or reinstatement. The measure of loss was not fixed by the policy, and could vary depending on the insured's intention for the property and its reasons for ownership.

The judge found the plaintiff, in fact, had no intention of rebuilding the property once it was destroyed in the final earthquake. The measure of its loss was accordingly the market value of the building it had lost, not the cost of its replacement. Although the building had suffered damage in earlier earthquakes, the plaintiff had not repaired the building, and so had suffered no additional loss.[7]

As a result, the payment under the settlement agreement was more than adequate to cover the plaintiff's loss (the insurer had agreed a generous market value). The judge nonetheless proceeded to consider the merits of the plaintiff's claim to set aside the settlement agreement.

The plaintiff alleged that Vero's representative had misrepresented its entitlements under the policy, thereby breaching the Fair Trading Act 1986, the insurance contract and the Fair Insurance Code. The judge held that in fact the plaintiff had been given a helpful and transparent explanation of its options. Vero's opinion of the correct basis for settlement and the approach to be taken to multi-event claims was commonly held (and reflected the views of the plaintiff's own lawyers). Such an opinion could not give rise to liability on any of the bases claimed. Furthermore, the plaintiff did not rely upon Vero, having obtained its own independent valuation and legal advice.

Of more general interest is the plaintiff's claim for relief under the Contractual Mistakes Act 1977. The judge held that if the plaintiff was now correct as to its entitlements, then the parties entered into the settlement agreement based on a mutual mistake. That mistake resulted in a substantially unequal exchange of values, which, in the absence of a contractual provision addressing the risk of mistake, would have given the Court discretion to set the settlement agreement aside.

However, the judge found the plaintiff agreed, under the terms of the settlement agreement, to accept the risk that it might have mistaken its rights. The agreement included a broad full and final settlement of claims *"arising directly or indirectly out of ... the policy and/or the Insured Property Damage ... [including] claims [which] ... are in existence now ... [whether] known or unknown [or] in the contemplation of the parties or otherwise"*. This clause, together with a recommendation that the plaintiff seek legal advice (which it did), meant that the plaintiff assumed the risk of a mistake.

The plaintiff also argued that there was no consideration for the settlement, as Vero was simply fulfilling its contractual requirement under the insurance policy. On the facts this did not hold up: there was a dispute as to the quantum of loss and the compromise of competing claims had real value. It is an interesting argument however, and worth bearing in mind in cases where sums due are liquidated or are readily assessed.

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[5] *Ridgecrest NZ Ltd v IAG New Zealand Ltd* [2014] NZSC 129, click here for our review of the decision
[6] *QBE Insurance (International) Ltd v Wild South Holdings Ltd* [2014] NZCA 447, click here for our review of the decision
[7] Relying on *Wild South*