Insurance Case Law Update

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In this update, we summarise insurance decisions issued at the close of 2013 and in first quarter of 2014. Litigation arising from the Canterbury earthquakes continues to dominate the insurance landscape, with the Supreme Court granting leave for the appeal of many of the judgments discussed in our December report.

There have now been several decisions dealing with question of whether an insured can claim for damage sustained in successive earthquakes. This is a vexed issue in claims where the building is underinsured or has ultimately been destroyed. There are conflicting High Court decisions on whether damage suffered in an earlier event merges in the final destruction of the building. The scope of the doctrine of merger was debated before the Supreme Court on 10 March 2014 at the hearing of Ridgecrest New Zealand Ltd v IAG New Zealand Ltd. The Court's judgment on the issue is awaited.

Detailed information on judgments having a wider impact on the insurance sector is linked to the case names highlighted in the summary table. For further information on any of the issues raised in this update, please contact Brett Morley (+ 64 9 375 8745) or Christina Bryant (+ 64 9 375 8789).

Summary Table

Case	Issues	Decision / Principle
BFSL 2007 Ltd v Steigrad (SC)	Application of **s9 of the Law Reform Act 1936** to costs-inclusive policies	The statutory charge under s 9(1) attaches to insurance proceeds that could be paid out under a liability policy. The insurer is at risk if it pays out defence costs under a costs-inclusive policy and the maximum level of cover is not sufficient to satisfy both the obligation to pay defence costs and the obligation to indemnify the insured if liability is established in the underlying claim.
Skyward Aviation 2008 Ltd v Tower Insurance Ltd (CA)	Interpretation of Tower's **Provider House Policy**	The insured, not the insurer, has the right to elect to reinstate the property and to choose between options for reinstatement. If the insured elects to purchase a replacement property, he or she is not obliged to purchase a property which is comparable with the original property when new.
Mr V v Sovereign Assurance Co Ltd (HC)	How insurers should approach an **assessment of entitlement** to a benefit	Sovereign made an assessment that an insured was not eligible for a benefit under an income protection policy. The judgment lists the principles the insurer must apply when exercising a contractual power to determine "to its satisfaction" whether a benefit should be paid.
Marriott v Vero Insurance New Zealand Ltd (HC)	Entitlement to recover **damage caused by successive earthquakes** **Automatic**	There was an automatic reinstatement of cover after each successive earthquake. Notice to prevent the automatic reinstatement had to be given before a further loss-causing event took place, but there was no implied term requiring notice to be given within a "reasonable period". Under the terms of the policy, the insurer could elect to pay the

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	reinstatement of cover When a property is **destroyed**	depreciated replacement cost of the buildings and had no obligation to pay for repairs unless and until those costs were incurred. "Destroyed" did not mean uneconomic to repair (a constructive total loss).
Crystal Imports Ltd v Lloyds (HC)	Entitlement to recover **damage caused by successive earthquakes** **Automatic reinstatement** of cover Application of the **doctrine of merger**	There was an automatic reinstatement of cover after each successive earthquake. Notice to prevent the automatic reinstatement had to be given before a further loss-causing event took place. The Court applied the doctrine of merger, with the result that the insured was only entitled to claim for the destruction of the building.
Sydenham Recycling Ltd v IAG New Zealand Ltd [2013] NZHC 3518	Scope of an **additional increased cost of working** provision under a business interruption policy	The purpose of the additional increased cost of working provision was to insure SRL for business interruption during the one year indemnity period. A claim for moving and re-housing the business would fall within the scope and purpose of the policy if there was a pressing need to relocate. However, the existing premises were safe to occupy due to temporary repairs undertaken by the insurer and SRL had successfully operated its business from those premises throughout the indemnity period.
Vero Insurance New Zealand Ltd v Weathertight Homes Tribunal [2014] NZHC 342	Scope and exercise of the **WHT's jurisdiction to remove a party** from proceedings	Successful application for judicial review of tribunal member's decision not to remove Vero as a party. WHT had jurisdiction to determine at an interlocutory stage which insurance policy applied and to construe an exclusion provision in that policy in circumstances where there was no genuine factual dispute. Section 11 of the Insurance Law Reform Act 1977 does not apply to exclusion clauses specifying the kind of loss or quantum of loss to which cover does not apply.
Angus v Ace Insurance Ltd [2014] NZHC 258	Whether a **fire was deliberately lit** by the insured	The balance of probabilities is the standard of proof in civil cases of suspected arson. The judge noted that the appearance of witnesses is of limited value in determining truth. Where possible, conclusions should be reasoned on the basis of contemporary materials, objectively established facts and the apparent logic of events.

Progress of Appeals

Case	Issues	Decision / Principle
Ridgecrest New Zealand Ltd v IAG New Zealand Ltd [2013] NZSC 108	Whether an insured is entitled to be paid for **damage caused by successive earthquakes** up to the limit of the sum insured	The hearing of the appeal to the Supreme Court took place on 10 March 2014. Judgment has been reserved. A summary of the Court of Appeal decision is included in our December update.
Jackson v IAG New Zealand Ltd [2014] NZSC 12	Whether **"in connection with"** requires a direct causal connection Dishonesty exclusion	Leave to appeal to the Supreme Court declined. The Supreme Court confirmed the test for dishonesty is a mixed objective-subjective test: a person's subjective knowledge is measured against "normally acceptable standards. A summary of the Court of Appeal decision is included in our December update.

Case	Issues	Decision / Principle
University of Canterbury v Insurance Council of New Zealand Inc [2014] NZSC 13	Whether local authorities can require owners to increase the **seismic strength** of buildings above 33% NBS	Leave to appeal to the Supreme Court granted. A summary of the Court of Appeal decision is included in our December update.
Firm PI 1 Ltd v Zurich Australian Insurance Ltd t/a Zurich New Zealand Ltd [2014] NZSC 19	Whether sum insured was **inclusive or exclusive of EQC** cover	Leave to appeal to the Supreme Court granted. A summary of the Court of Appeal decision is included in our December update.
Fowler Developments Ltd v Minister for Canterbury Earthquake Recovery	**Lawfulness of 50% rateable offer** to owners of vacant land and uninsured improved properties in the red zone	Fowler Developments Ltd and the Quake Outcasts have applied for leave to appeal; the Supreme Court's decision on the application for leave has yet to be delivered. A summary of the Court of Appeal decision is included in our December update.

BFSL 2007 Ltd v Steigrad [2013] NZSC 156

On 23 December 2013, the Supreme Court delivered a controversial decision on the operation of s 9 of the Law Reform Act 1936 on costs-inclusive liability policies, which is likely to have ongoing adverse consequences for insurers and their insureds.

Section 9(1) of the Law Reform Act 1936 provides:

> If any person (hereinafter in this Part referred to as the insured) has… entered into a contract of insurance by which he is indemnified against liability to pay any damages or compensation, the amount of his liability shall, on the happening of the event giving rise to the claim for damages or compensation, and notwithstanding that the amount of such liability may not then have been determined, be a charge on all insurance moneys that are or may become payable in respect of that liability.

The receivers of the Bridgecorp group of companies and representative shareholders of Feltex Carpets Ltd (in receivership) brought claims against the directors and former directors of those companies. The directors sought cover for their defence costs under certain insurance policies, which provided both an indemnity for the directors' liability for third party claims and cover for their defence costs. Under the terms of the policies, defence costs were payable as they fell due, but third party claims became payable only when liability was established, by a judgment or by settlement. The policies were "costs-inclusive": payment of any defence costs reduced the total amount available for payment under the indemnity.

The receivers and shareholders argued that the charge created by s 9(1) secured the maximum cover available under the policy for the indemnity from the date of the act or event giving rise to their claim. The maximum sum secured by the charge could not, they claimed, be depleted by the payment of defence costs in the interval between the creation of the charge and the date of judgment or settlement.

The contrary argument, supported by a minority of two judges in the Supreme Court, was that the charge under s 9(1) attached to the contractual right to an indemnity under the policy. The scope of that right (including the amount which must be paid) depended on the factual circumstances at the time the insurer was required to make payment under the indemnity. If the insurer had already paid out defence costs in accordance with its obligations under the policy, then the maximum amount payable under the indemnity was reduced in accordance with the policy terms.

Notwithstanding the force of this argument[1], the majority held that the charge attaches to the maximum amount of cover that could ever be paid under the policy. As a result, the insurer is "at peril" if it complies with its contractual obligation to pay defence costs in circumstances where there is insufficient insurance cover to meet both insurance obligations (namely the obligation to indemnify and the obligation to pay costs).

Unhelpfully, the majority did not address whether an insurer is entitled to refuse to pay defence costs in those circumstances. Faced with a costs-inclusive policy and a claim that may exceed the policy limit, insurers have the unappealing options of breaching the contract with their insured, extending their risk above the maximum policy limit and/or litigation to establish whether or not their contractual obligation can be avoided.

Section 9 has general application to liability insurance policies. While the industry response to the High Court judgment in *Steigrad* has seen a move away from costs-inclusive policies, litigation has a very long tail. The judgment may have an ongoing impact on existing litigation claims, claims for which precautionary notifications have been made under costs-inclusive policies and project-specific policies under which claims have yet to surface. Insurers and insureds will need to review the status of notifications made under such policies, and consider their options for addressing liability for costs if and when a claim eventuates.

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[1] Which is largely consistent with the judgment of the Full Court of Appeal of New South Wales in *Chubb Insurance Co of Australasia Ltd v Moore* [2013] NSWCA 212, (2013) 302 ALR 101

Skyward Aviation 2008 Ltd v Tower Insurance Ltd [2014] NZCA 76

Skyward and *O'Loughlin*[2] concern the interpretation of Tower's Provider House Policy. The judges dealing with the claims in the High Court largely agreed on the policy's meaning (see our December 2013 update). The plaintiffs in *O'Loughlin* settled their claim with Tower; *Skyward*, however, was successfully appealed.

Skyward owned a rental property in the red zone comprised of a house and sleep-out. The pre-earthquake value of the land and buildings was around $492,000. CERA purchased the land for $291,000 and EQC paid the plaintiff the statutory limit for damage to the buildings. The litigation concerned the level of the top-up payment payable by Tower for the building damage.

Tower's Provider House Policy included an option to purchase cover for the "full replacement value" of the insured house. "Full replacement value" meant "the costs actually incurred to rebuild, replace or repair your house to the same condition and extent as when new and up to the same area as shown in the certificate of insurance, plus any decks, undeveloped basements, carports and detached domestic outbuildings, with no limit to the sum insured." Skyward had purchased full replacement cover.

Skyward's house was damaged beyond economic repair. The policy provided that "full replacement" could accordingly be effected in one of three ways: by rebuilding the house at the original site, by building on another site chosen by the insured or by buying another house. The cost of the second two options could not exceed the cost of the first.

Tower claimed that it could settle Skyward's claim by paying an amount equivalent to the cost of buying a comparable property. Tower estimated this cost at $365,000 (excluding the cost of land). It accordingly paid Skyward $165,000 on top of the $203,000 already paid by EQC. This meant that Skyward was paid a total of $659,000 for the land and buildings (the aggregate of the CERA, EQC and Tower payments).

The Court of Appeal held that:

1. The terms of policy, properly construed, gave the insured (not Tower) the right to chose whether or not to reinstate the property. If the property was damaged beyond economic repair, Skyward could chose between three reinstatement options (rebuilding on the original site, building on another site or buying another property).

2. If the insured decided to reinstate by purchasing another property, he or she was not obliged to purchase a property which was comparable with the existing property when new. The sole constraint was the price, which could not exceed the nominal cost of rebuilding the insured house on the original site.

In support of its judgment on the first issue, the Court referred to various policy terms which implied that the power to choose was held by the insured. The clause relied upon by Tower, which stated *"In all cases… we [Tower] have the option whether to make payment, rebuild, replace or repair your house"* meant only that Tower had the option of reinstating the property itself (rather than paying the insured's costs in doing so). This interpretation does not fit comfortably with the inclusion of replacement in the list of options, unless replacement is read to mean only the option of building on another site.

The Court's judgment on the second issue is perhaps more interesting for parties other than Tower and its policy holders. The widespread nature of the damage arising from the Canterbury earthquakes has had an adverse impact on the resources available to effect repairs, and construction costs can exceed the capital value of the rebuilt house. Those increased costs do not fall on insureds with full replacement cover, who are entitled to receive the equivalent of their houses when new. As the Court noted, that is fair enough: the insurer contracted to provide cover on a new for old basis. It is less evident, however, that inflated building costs caused by a natural disaster should be used to justify a claim for the purchase of a house which is significantly better than the insured property when new, in terms of its amenity and its capital value.

Tower's estimate of the price to purchase the equivalent of the insured house when new was $365,000 (excluding the price of the land). The Court of Appeal's decision that the only constraint on the plaintiff's right to purchase a property was the cost of rebuilding the original house ($680,000) meant that Skyward

[2] [2013] NZHC 670, [2013] 3 NZLR 275

could purchase a property worth an additional $315,000. As a result, the insured was not only entitled to upgrade its old house to a new one, it could also upgrade a modest house to a luxury home (depending on the state of the housing market at the time of purchase).

Fairness, of course, is not strictly relevant to contract interpretation: the question is what, from an objective standpoint, the parties intended their contract to mean. The Court of Appeal took the view that the terms of the policy meant that if Skyward elected to reinstate, Tower's liability was set at the nominal cost of rebuilding the insured house on the original site. Tower had no ongoing interest in how the money was spent (provided it was spent). The alternative argument, that the intention of the policy was only to provide Skyward with a house equivalent to the insured house when new, was not favourably received.

It will be interesting to see whether Tower seeks leave to appeal the judgment to the Supreme Court. We will provide an update in due course.

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Mr V v Sovereign Assurance Co Ltd [2013] NZHC 3051

Mr V was a member of a group insurance scheme for income protection. He suffered from chronic pain syndrome, which prevented him from working in his former occupation. Under his policy, Sovereign could cease payment of his benefit after two years if it considered on reasonable grounds that he was not suffering from a total disability. Sovereign obtained expert opinions from an occupational physician and a vocational assessor, and decided that Mr V was no longer entitled to a benefit.

The Court identified the following principles that an insurer should follow when making a decision on whether an insured is entitled to a benefit:

1. The insurer should interpret the policy to determine the correct questions in issue.

2. Where an expert opinion is sought, the expert should be provided with all the relevant information.

3. The expert must be asked the correct questions. However this does not require the insurer to request the expert to analyse specific policy provisions, where the insurer is not delegating the determination to be made to the expert.

4. The insurer is bound by a duty of good faith and fair dealing.

5. The insurer must have due regard for the interests of the insured, but this duty is contractual, not fiduciary.

6. Where a state of affairs governing the entitlement to a benefit turns on the opinion of the insurer, the insurer must act reasonably in considering the matter and forming its opinion.

7. The insured bears the onus of proof in both the original claim and any review application.

The Court will not substitute its judgment for that of the insurer. If the insurer has addressed itself to the right questions and taken account of the relevant information available to it, and the decision reached is reasonably open to the insurer, the Court cannot intervene. This test is similar to the *Wednesbury* principle applied in judicial review applications.

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Marriott v Vero Insurance New Zealand Ltd [2013] NZHC 3120

This claim, *Wild South* and *Crystal Imports*[3] all involve the application of an automatic reinstatement clause in a policy, in circumstances where the insured property sustains damage in successive earthquakes. Both *Marriott* and *Crystal Imports* make it clear that reinstatement occurs at the time of damage, and notice that cover will not reinstate must be given before a further event occurs giving rise to a right of claim under the policy.

Unlike *Wild South*, the judge in *Marriott* declined to imply a term that notice must be given within a reasonable period of the event triggering the reinstatement of cover. The judge noted the commercial common sense of providing for a period of notice before the removal of reinstatement took effect, to give the insured an opportunity to arrange alternative cover. However, this would require the implication of an additional term, which was not tested in argument and not warranted in the *Marriott* case.

The *Marriott* decision also considered the question of when a building should be treated as destroyed. The depreciated market value of the two small commercial buildings owned by the Marriotts was $460,000 plus GST. The buildings were damaged in earthquakes on 4 September 2010 and 22 February 2011. Although the buildings continued to be occupied by tenants, the insurer took the view that they were destroyed in the February event as they were uneconomic to repair (a constructive total loss).

The issue was important, as the Marriotts were claiming for additional damage caused in a later earthquake on 13 June 2011 (the total claims package was some $2.045 million). If the property had already been destroyed, there could be no further claims following the February event.

The judge held the use of the term “destroyed” in the policy related to the property’s physical state. A building is destroyed if the extent of the damage is such that it is impracticable to repair it in a way that restores it to its pre-earthquake condition.

As is the case with many policies currently under review, the *Marriott* policy provided traditional indemnity cover for loss or damage to the property (“old for old” cover), with an extension providing replacement/reinstatement cover on a “new for old” basis. The obligation to pay the indemnity cover arose at the time of damage; the additional liability for replacement costs arose when those costs were incurred.

Vero had the power under its policy to elect how its indemnity obligation was to be quantified. It had elected to pay the indemnity based on the depreciated replacement cost of the buildings and accordingly had no obligation to pay repair costs unless and until those costs were incurred. As a result, the insured could not pursue a claim for repair costs up to the value of the sum insured for each event.

Finally, the *Marriott* decision confirmed that, in the absence of a contractual provision to the contrary, the excess should be deducted from the payment due under the policy, as opposed to the total amount of the insured’s loss.

Marriott, *Crystal Imports* and *Wild South* are all being appealed, with a hearing expected later this year. We will provide an update once the judgments are available.

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[3] Wild South Holdings Ltd v QBE Insurance (International) Ltd [2013] NZHC 2781, Crystal Imports Ltd v Certain Underwriters at Lloyds of London [2013] NZHC 3513

Crystal Imports Ltd v Certain Underwriters at Lloyds of London [2013] NZHC 3513

Like *Ridgecrest, Marriott* and *Wild South,*[4] this claim concerns damage sustained by an insured property in successive earthquake events. The question arising in all of these claims is whether the insured can claim the cost of remedying damage caused by each earthquake. *Crystal Imports* is of particular interest due to Cooper J's decision that the doctrine of merger applied to the material damage policy at issue in that proceeding.

Crystal Imports owned five properties in Christchurch damaged in the 4 September 2010 earthquake and the 22 February 2011 earthquake. The insurer had paid $70,000 towards investigation and repair when the February earthquake struck, but the majority of the repairs had not been done. Three of the five properties were subsequently demolished.

The insurance policy included a provision for the automatic reinstatement of cover following an event of loss, unless either party gave written notice to the contrary. Notice was not given in the period between the two earthquakes.

The Court held that the insured's right to be indemnified by the insurer arose when physical damage to the property occurred during each earthquake. Cover was reinstated at the same time. Subsequent notice to the contrary would mean that the reinstatement of cover was not effective, but notice had to be given before a further loss-causing event took place.

The insured was accordingly entitled to have the property reinstated after each earthquake up to the maximum limit of cover. However, the Court held that the doctrine of merger means that a partial loss which is not repaired merges into a subsequent total loss. As a result, the insured was only entitled to claim for the total loss in the February event, although the insurer remained liable for the cost of investigations and repairs which had already been incurred.

The doctrine of merger has only previously been applied in marine insurance cases, where the obligation to pay for unrepaired damage to a vessel does not arise until the repairs are undertaken. Cooper J disagreed with the High Court judgment in *Ridgecrest*, where Dobson J took the view that merger does not apply to wider categories of material damage insurance. The Court of Appeal in *Ridgecrest* did not express a view, but the issue was the subject of extensive argument before the Supreme Court. The Supreme Court's judgment, which has yet to be delivered, may clarify the issue of whether merger applies to event-based policies, where liability arises when the damage is incurred.

Crystal Imports also reviewed the meaning and effect of an Average provision in the policy. Average clauses address under-insurance, by reducing the amount payable under the policy for loss in proportion to the difference between the sum insured and the true value of the property. The dispute in *Crystal Imports* concerned the basis on which the true value should be calculated; the insured asserted the value was the depreciated replacement cost at the time of the February earthquake ($4,580,000), the insurer said it was the full replacement cost on the same date ($9,569,320). The former measure would limit recovery to 67% of the loss, the latter to 32% of the loss.

The judge held that the appropriate measure depended on whether Crystal Imports elected to reinstate the property. The policy included a reinstatement memorandum ("new for old" cover), which did not apply if the insurer chose not to reinstate. The policy did not specify the method by which the indemnity would be calculated in that event. The Court held that "generally applicable principles" meant that the indemnity would be based on the depreciated replacement cost of the property or the market value loss. If Crystal Imports elected not to reinstate, the true value of the property for applying Average was the depreciated replacement cost.

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[4] Ridgecrest New Zealand Ltd v IAG New Zealand [2013] NZCA 291, [2013] 3 NZLR 618 (CA), Marriott v Vero Insurance New Zealand Ltd [2013] NZHC 3120, Wild South Holdings Ltd v QBE Insurance (International) Ltd [2013] NZHC 2781