

# Insurance Law Update 2009

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## ***Trustees Executors Ltd v QBE Insurance (International) Ltd* (HC Auckland, CIV 2009-404-1165, 9 October 2009, Ronald Young J)**

This case was concerned with the interpretation and effect of a Securities Exclusion clause in a PI policy that QBE provided to TEL. That exclusion has become reasonably common in PI policies, and is of considerable relevance in the current economic environment.

TEL as part of its business provided investment administration services and mortgage lending. It was a trustee and manager of a mortgage fund operated by Tower. In 2007 16 of the loans made by the fund were in default. These loans had been made by TEL outside the approved loan criteria in its management agreement with Tower. For example:

1. Loan to value ratios had not been followed.
2. Property values on which such ratios were based were exaggerated.

In early 2008 Tower notified TEL that it considered TEL had breached the management agreement and it would hold TEL liable for losses. TEL notified QBE. A settlement was reached between Tower and TEL. QBE gave its consent to the settlement reserving its rights on indemnity.

In due course QBE declined TEL's claim to be indemnified. While Tower's claim was within the operative clause of the policy, QBE said it was excluded by the Securities Exclusion, which provided:

... this Policy does not provide indemnity against any Claim or Claims arising from or contributed to by depreciation (or failure to appreciate) in value of any investments ... or as a result of any actual or alleged misrepresentation, advice, guarantee or warranty provided by or on behalf of the insured as to the performance or characteristics of any such investments.

QBE relied on the underlined part of the exclusion.

TEL sued QBE, seeking a declaration, in effect, that the Securities Exclusion did not apply. An initial issue for the Court was whether the declaratory judgment process was appropriate. The Court held that it was appropriate, rejecting QBE's opposition.

The first substantive issue was about the meaning of the words "depreciation (or failure to appreciate)" in the exclusion. TEL said that the words referred only to a loss of an investment caused by market fluctuations or as a result of a mixture of market fluctuations and negligence by an insured. On this meaning presumably some or all of Tower's claim would have been outside the exclusion, though this was not a matter that the Court was called upon to determine. QBE said that the words excluded any loss in the value of investments including any loss arising from the negligence or contractual breach of the insured.

The Court rejected TEL's interpretation. The ordinary meaning of "depreciation" was loss of value, howsoever caused. There was nothing in the policy or in the surrounding circumstances to suggest that the parties had objectively intended that the exclusion was limited to losses in value of investments caused by market fluctuations.

That left the second substantive issue: causation. TEL said that, even on QBE's interpretation of the exclusion, Tower's claim did not arise from, nor was it contributed to by, the depreciation in investments and therefore the exclusion did not apply. TEL said that Tower's claim was caused, not by the fall in value of the investments, but by the negligent action of TEL (eg, in lending outside the agreed loan criteria).

Unsurprisingly, the Court did not accept this argument. The exclusion used the words "arising from or contributed to by" to describe the requisite causal connection between the claim (by the third party) and the depreciation in value of investments. There is ample authority that those words describe a very wide causal connection. Moreover, it was clear that Tower's claim did arise from, or was contributed to by, the loss in value of the mortgages. As the Court pointed out, there were other instances of mortgage lending by TEL that was unauthorised and negligent, but which caused no loss to Tower.

TEL finally argued that the exclusion did not exclude losses arising from unauthorised investments. TEL relied on an Australian case, *Done v Financial Wisdom Limited* [2008] FCA 1706 (FCA), in which the Court had concluded that a similar exclusion applied only to authorised investments. But the exclusion in *Done*, though similar, expressly provided that it did not apply to any claim arising from the insured's failure to effect a specific investment transaction pursuant to a specific instruction. That proviso is quite common in these exclusions, but was absent from the QBE policy, and so there was no basis for limiting the exclusion in the way that TEL sought to.

This case confirms the wide ambit that these exclusions can have (but also that their width depends on the particular words used). The width of such exclusions can leave insureds wondering what cover they are obtaining from the policy. That was a point made by TEL in this case, but it did not impress the Court – and rightly so. There was no suggestion that QBE had misrepresented the extent of cover that would be provided by the policy.

There is, however, a further argument that does not appear to have been raised in this case – perhaps because the facts could not support it. The central idea of the exclusion is that there has been depreciation in value in an investment. It is possible to conceive of a loss of an investment, or of part of an investment, that does not fit within the concept of “depreciation in value”. Assume, for example, that TEL had negligently advanced a mortgage loan in circumstances where, from the moment of the advance, the mortgage had no value (because the borrower was a fraudster, and the security was worthless) or had a value less than the advance. It seems difficult in those circumstances to call the immediate loss in value a “depreciation” in value in the mortgage.

***Body Corporate No 205963 v Leuschke Group Architects Limited (in liquidation)***  
**(HC Auckland, CIV 2006-404-5572, 9 December 2008, Stevens J)**

You can tell from the names of the parties that this was concerned with leaky apartment units. The unit owners sued the defendant architect, all other possible parties having been placed in liquidation. In due course the architect also went into liquidation, at which point the unit owners joined the architect’s PI insurers, Lumley and ACE, as second defendants. When joining the insurers the Court ordered that there be a preliminary trial of the question whether an exclusion clause in the PI policy excluded cover for the plaintiffs’ claim against the architect. The relevant clause, 2.04, provided:

The Companies shall not indemnify the insured against liability:

for loss or damage of whatsoever nature to any building or structure arising directly or indirectly from moisture or water ingress through any exterior cladding or roofing system (and any associated waterproofing treatment and flashings) designed, specified or approved by the insured, including but not limited to monolithic claddings and face sealed systems, fibre cement sheets, expanded polystyrene sheets, cellulose fibre sheets, PVC sheets, stucco plaster and proprietary plaster systems.

This exclusion shall not apply to any exterior cladding system, the design of which allows or promotes the ready escape of moisture and moisture vapour.

Specifically, the question was whether the exclusion applied to exclude the liability of Lumley and Ace arising out of damage to the plaintiffs' property from water entry and moisture damage via metal balustrades being fixed through decks, metal caps being fixed through the top vertical surfaces of balconies, and penetration of storm water downpipes.

The first issue was as to the proper interpretation of the exclusion. The focus was on the words:

any exterior cladding or roofing system (and any associated waterproofing treatment and flashings)

The insurers argued that these words should be interpreted so that:

1. The word "system" applied to "exterior cladding" (as well as to "roofing"); and
2. The words in brackets applied to "exterior cladding" (as well as to "roofing system").

Stevens J rejected the first argument. His Honour held that the clause was ambiguous, and that the ambiguity should be resolved against the insurers. This holding, with respect, is difficult to accept, for two very good reasons that were advanced by the insurers. Any ambiguity was resolved once the clause was read as a whole, because (1) the middle paragraph of the exclusion went on to refer to "monolithic claddings and face sealed systems" and "proprietary plaster systems", and (2) the write back in the final paragraph said that the exclusion shall not apply to any "exterior cladding system" that was designed to allow the escape of moisture. There seems little point in expressing the write back in that way if (as the Court held) the exclusion did not apply to an "exterior cladding system".

Stevens J said several times that it would have been a simple matter for the insurers to have added "system" after "exterior cladding". That's true enough, but seems to me to be of much less force than the clear indications from the other parts of the exclusion. This sort of approach to interpretation simply leads to "defensive drafting", in which policies become unduly wordy – for which the insurers will then be criticized by some later court.

His Honour also rejected the insurers' second argument. In his view the natural and ordinary meaning was that the words in brackets, since they immediately followed the words "roofing system", applied only to those words. Again His Honour said that it would have been very easy for the insurers to make the bracketed words apply also to the words "exterior cladding".

The next issue was whether the exclusion, as interpreted, applied to the particular types of damage before the Court. Stevens J held that the exclusion did not apply to any of the damage. I won't discuss that issue, as it was simply a factual one, and a discussion would require me to descend into technical building language.

***Gerling Australia Insurance Co Pty Ltd v Ludgater Holdings Limited* [2009] NZCA 397**

This case raised questions about the territorial scope of s 9 of the Law Reform Act 1936. That is the "direct recourse" provision, allowing a claimant to directly sue a wrongdoer's liability insurer in certain circumstances – most commonly when the wrongdoer is insolvent.

The respondent, Ludgater, owned a building in Auckland that was damaged by fire in 2006. Ludgater alleged that the fire was caused by a defective capacitor in one of the lights. The capacitor was manufactured in Australia by Atco, an Australian company that was now in liquidation. The appellant, Gerling, had provided product liability insurance to Atco. That policy appeared to cover Atco for any liability that it might have to Ludgater.

The policy was issued to Atco in Australia. Gerling's principal place of business was Sydney. Atco's was in Melbourne. The policy was governed by Australian law. Gerling had briefly carried on business in NZ, but had ceased doing so in 2003.

Ludgater applied in the High Court at Christchurch for leave to commence proceedings against Gerling under s 9. Associate Judge Christiansen granted leave. That decision was upheld on a review to Chisholm J, and Gerling appealed to the Court of Appeal.

Section 9(1) relevantly provides that:

If any person ... 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 ... be a charge on all insurance money that is or may become payable in respect of that liability.

On its face s 9(1) applied to the circumstances of this case. However, as the Court of Appeal noted, the section is silent as to its territorial application. When legislation is silent on the matter, the presumption is that Parliament did not intend to legislate extraterritorially.

The appeal raised issues that are primarily concerned with the conflict of laws, on which I cannot and will not speak in any detail. What's of interest to this audience is the ultimate outcome in terms of use of s 9.

The main question was whether the High Court had jurisdiction to hear and determine Ludgater's application for leave. The CA broke that issued down into two specific questions:

1. Whether the High Court had "in personam" jurisdiction over Gerling.
2. Whether the High Court has "subject-matter" jurisdiction in an action under s 9 where the contract is governed by foreign law and the insurance money is situated (payable) in another country.

The first of those questions is, to an extent, a procedural question. The High Court Rules determine when a defendant can be served abroad. Those Rules distinguish between different types of claims that a plaintiff may make. Very generally, if the claim is in contract, then a defendant can be served abroad only if the contract had some connection to NZ – for example, if it was made here, was to be performed here (in part or whole), or was governed by NZ law. If the claim is in tort, a defendant can be served abroad if the relevant act or omission for which damages are claimed was done in NZ, regardless of whose act is in question. Under this first issue, the question was whether a claim under s 9 should be characterised as a claim under the insurance contract (in which case the High Court did not have jurisdiction, since the insurance contract was entered into and to be performed in Australia), or as a claim in tort (in which case the High Court did have jurisdiction, since the fire occurred in NZ). The Court of Appeal, after considering cases from NZ, Australia, England and Canada (which were divided on this question), concluded that the action under s 9 was properly characterised as tortious.

However, that Gerling was properly served under the High Court Rules was not the end of the matter. That's because there are still limitations on the territorial jurisdiction that a court has, reflecting the subject matter before it. As the Court of Appeal put it, if a successful action under s 9 would create a charge that was situated (enforceable) in Australia (specifically NSW), then a NZ court should not accept jurisdiction, because it would be "trespassing" on the jurisdiction of the NSW court. The Court of Appeal concluded that that was indeed the case here, and so the Court did not have jurisdiction.

It seems therefore that in a situation such as this Ludgater's only avenue is to pursue Gerling through the equivalent direct recourse provisions that apply in some Australian jurisdictions.

Ludgater has applied to the Supreme Court for leave to appeal.

I do not profess any expertise in the conflict of laws, but the Court of Appeal's decision seems right. Though this was not mentioned in the Court of Appeal's judgment, s 9 is an aspect of insolvency law, in that it overrides the ordinary *pari passu* rule by giving the plaintiff a priority to the insurance moneys over the insured's other creditors. Atco would presumably be subject to the insolvency laws of some Australian jurisdiction. Assuming that that jurisdiction required Atco's liquidator to recover from Gerling the insurance moneys for the benefit of Atco's general body of creditors (and it would be surprising for that jurisdiction to allow a NZ enactment to affect the distribution of Atco's assets), great difficulty would be caused for Gerling if at the same time it faced a competing action by Ludgater in NZ for the same money. In that sense a NZ court would be trespassing on the Australian jurisdiction if it allowed a direct action by Ludgater to proceed.

***Arrow International Limited v QBE Insurance (International) Limited* (HC Wellington, CIV 2007-485-74, 23 June 2009, McKenzie J)**

Arrow was head contractor for the Luxford Villas apartment development, responsible for design and construction (though it subcontracted all of that work). The apartments achieved practical completion in December 2000.

The apartments leaked like so many sieves. The leaks caused extensive rotting and water damage to timber.

The rotting and water damage was first discovered in August 2003. In due course the building owners sued Arrow for the estimated cost of remedial work. Arrow settled that claim at mediation, at a net payment (after recoveries from some other parties) of \$3.78 million.

Arrow was insured with QBE under a general liability policy that ran, with renewals, from 30 May 2002 to 30 May 2005. The policy provided an indemnity for Arrow's legal liability to pay compensation "consequent upon accidental physical ... damage to any tangible property ... happening ... during the Period of Insurance". There was an exclusion for "liability for the cost of rectifying any defect in any Product". For the 2004/2005 policy a further Building Defects exclusion was added (though in the end this did not become relevant).

QBE declined to indemnify Arrow. QBE's primary position was that Arrow's liability was consequent upon damage that had happened prior to inception, and was therefore not within the insuring clause. As a fallback, QBE said that the defective products exclusion operated to exclude cover for a substantial portion of the liability. That also gave rise to

a quantum issue: if the exclusion did apply, how much of the settlement sum should be apportioned to the (excluded) costs of rectifying the defects? The settlement agreement, as is usual, did not apportion the settlement sum between the different parts of the building owners' claim.

MacKenzie J began with some important factual findings. He held that the damage that led to the need for remedial work was the result of a process of decay that was continuous from prior to inception on 30 May 2002 (para 32). The damage was continuous and latent (para 38).

Arrow's primary position (in summary) was that it was entitled to be indemnified in full by QBE, so long as some of the damage occurred while QBE was on risk (even if some damage had already occurred prior to inception. QBE, by contrast, argued that the policy responded, if at all, only if damage occurred during the policy period.

This dispute required MacKenzie J to interpret the insuring clause to determine what was the "trigger" for cover. His Honour first said that the interpretation of QBE's policy should not be influenced by "public policy" arguments (para 48). The public policy arguments that his Honour was referring to are arguments, favoured in some United States jurisdictions, that insurance policies should be interpreted in such a way as to make as many insurers as possible have to indemnify. Instead, MacKenzie J said that the search for a trigger for coverage under a public liability policy "must be firmly grounded in the policy wording". His Honour rejected what is sometimes called a "continuous trigger" approach favoured in some United States jurisdictions. The word "happening" in the insuring clause was intended to fix a single point at which coverage under the policy was triggered (para 49).

His Honour also rejected Arrow's secondary argument, namely that damage "happened" only once it became manifest (ie, when discovered in August 2003). The policy covered "damage happening during the policy period, not damage becoming manifest during the policy period" (para 66).

The expert evidence from both sides was that there was more than minimal damage prior to inception (para 83). Arrow's claim therefore was outside the insuring clause (para 86). That even more damage may have happened after inception did not assist Arrow, because his Honour had held that the policy required him to find a single point at which cover was triggered (para 49).

MacKenzie J's approach to interpretation, relying on the words of the policy, rather than re-writing the policy, is to be welcomed. However, it is difficult to see why the word "happening" in the insuring clause was intended to fix a single point in time at which cover was triggered. There is no reason why the insuring clause should not respond in a continuous or repeated way, if there is continuous or repeated instances of damage. On

the natural and ordinary meaning of the insuring clause, there was “damage to ... property ... happening ... during [2003]” just as much as there was “damage to ... property ... happening ... during [2002]”. The policy does not make these mutually exclusive states of affairs.

That is not to say that the mere happening of damage during a policy period would have entitled Arrow to indemnity. Arrow would be entitled to indemnity only if its liability to the building owners was “consequent upon” damage happening during a period of insurance. Here, the extent of damage prior to inception was such that the remedial work that would then have been required was broadly similar to that which was eventually required (para 84). That meant that any liability to the building owners was consequent upon the damage that had happened pre-inception, and not consequent upon the damage that happened while QBE was on risk.

Finally, even if Arrow’s claim had been within the insuring clause, MacKenzie J was of the view that the building was a “product”, and so the defective products exclusion would have applied. In that event QBE would not have been liable for the cost of rectifying or repairing the defects (paras 89 and 92). It would then have been necessary to apportion part of the settlement sum to those excluded costs, an apportionment that would have required consideration of the settlement negotiations.

***Arnold v American International Assurance Co (Bermuda) Limited (HC Auckland, CIV 2008-404-6987, 4 June 2009, AJ Abbott)***

***Sovereign Assurance Co Limited v Scott (HC Rotorua, CIV 2008-463-909, 30 September 2009, Allan J)***

Both these cases concerned the issue of the limitation period that applies to claims under insurance policies. This is an issue that has not often been raised in NZ.

In *Arnold* the plaintiff and his late wife had taken out a joint life insurance policy with AIG. The policy provided for the payment of a benefit in the event that a life insured was diagnosed with a terminal illness:

Should the Life Assured be diagnosed by a Medical Physician ... as having an illness which is likely to result in the death of the Life Assured within 12 months ... a lump sum ... will be paid.

Mrs Arnold (the deceased) was diagnosed with a terminal illness in early 2001. She died four years later. For reasons not apparent in the judgment, the policy was cancelled at the insureds’ request as from 3 June 2001. In September 2007 Mr Arnold

submitted a claim for payment of the terminal illness benefit. He commenced proceedings in 2008. This was more than six years after diagnosis.

In *Sovereign v Scott* Mr Scott had a critical illness cover policy. It provided for a payment of \$100,000 on the occurrence of any one of a number of defined events, including stroke. On 1 January 1997 Mr Scott suffered a subarachnoid haemorrhage. A couple of weeks later he submitted a claim to his insurer for a stroke. The insurer declined the claim, on the grounds that the definition of stroke in the policy required that there be significant permanent neurological damage – which the insurer claimed was not present. About two years later, after complaining to his GP about further symptoms, Mr Scott asked the insurer to reconsider. In July 1999 the insurer confirmed its earlier decision to decline the claim. Mr Scott cancelled his policy in April 2002. In 2005 he renewed his claim again. After a further declination, he commenced proceedings in September 2006 – more than nine years after the alleged stroke.

Going back to *Arnold*, Associate Judge Abbott held that time commenced to run, for the purposes of the Limitation Act, as soon as the insured event occurred, and not at some later date (such as when a claim was declined by the insurer). He cited ample English authority in support of that view. It followed that the claim was time barred, unless a term could be implied into the contract. In *Scott*, Allan J adopted the reasoning of AJ Abbott.

On the view adopted in these two cases, the insurer is in breach of contract as soon as the insured event occurs. This view makes sense only if we assume that what the insurer is promising in the contract is that the insured event *will not happen*. I've never seen an insurance contract expressed in that manner, and in my view it's only (some) insurance lawyers who conceive of the contract in that way. What the insurer is promising, in my view, is that if the event happens, then the insurer will provide a benefit (indemnity, or a fixed sum). Nonetheless, it is undoubtedly the case that English law has adopted the odd conception of insurance that was applied in *Arnold* and *Scott*. But NZ and Australia have not. There are plenty of Australasian authorities holding that the insurer's obligation is to pay a claim within a reasonable time of it being made (see, for example, *Stuart v GRE*, *NZI v Harris*, *Protean (Holdings) v American Home*, *Moss v Sun Alliance*). It is only if the insurer has failed to pay the claim that the insurer is in breach. None of those authorities were referred to in either *Arnold* or *Scott*.

To anticipate a possible objection to the view that time should commence to run only once the insurer has declined a claim, there should be no concern that insureds might delay making claims so that they can postpone the limitation period. There are so many other downsides in delaying a claim that there is no incentive for the insured to delay.

