THE CHRISTCHURCH EARTHQUAKES INSURANCE AND REINSURANCE ISSUES

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I. The Background

A. The Scenario

New Zealand's nickname as the "Shaky Isles" is well deserved, with the monitoring organisation, Geonet, recording more than 15,000 earthquakes per year, although only about 150 of those are usually felt.[1] Recent earthquake activity has been pronounced, and there have been eight major events since 2007.[2] Christchurch has suffered particularly badly, having faced a serious earthquake on 4 September 2010 and "The Big One" on 22 February 2011. The latter was less intense than the former, measuring 6.3 on the Richter Scale[3] as opposed to the earlier 7.1, and appears to have been, at least in technical terms, an aftershock, but it proved to be much more devastating because it occurred on a fault line much closer to the city. it occurred on a fault line much closer to the city.[4] Some 185 people lost their lives and the costs of property damage have yet to be fully estimated. Nevertheless, Geonet described Christchurch as having been "comparatively lucky" as regards both the timing and the location of the event. That said, many of Christchurch's most famous buildings were lost, including two cathedrals. Well over one-third of the buildings in the Central Business District were damaged beyond repair, and it is estimated that some 1,000 of the 1,300 commercial buildings in the area surrounding the CBD will have to be demolished. The worst affected areas, including large parts of the east of the city, have been designated as a "Red Zone", and this area is to be evacuated. Some 6,000 people have been affected by this. The Canterbury Earthquake Recovery Authority (CERA)[5] has been established to co-ordinate the recovery effort in the wake of the two earthquakes, and one of its roles has been to buy out property owners in the Red Zone.

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1 <www.geonet.org.nz>.

2 <www.geonet.org.nz>.

3 The Richter Scale measures energy release, and is a less useful measure than the Mercalli scale which measures ground acceleration, the latter being the cause of damage.

4 <www.teara.govt.nz>.

5 <cera.govt.nz>.

Although many residential buildings were not damaged directly by the shaking from the earthquake itself, losses flowed from the process of liquefaction. In essence, much of the area on which Christchurch is built consists of compressed sandy soil, and indeed the eastern parts of the city were built on swampland. The compressed surface soil kept the underlying water at bay, but the vibrations from the earthquake broke up the soil and allowed pressurised water to escape, converting much of the soil into sludge and mud. Matters were exacerbated by the fracturing of sewer pipes, releasing large quantities of sewage. That rather unpleasant cocktail submerged whole streets and houses, and, even where the levels reached were relatively low, the effect on the foundations of houses was devastating. The surface soil in certain areas has become so unstable that those areas have been written off in terms of suitability for reconstruction.

It is against that catastrophic background that the adequacy of insurance arrangements has come into sharp focus. The cumulative losses have been estimated to constitute the world's third biggest insurance "event" in the last 50 years. This paper looks at some of the issues that have arisen and may arise. As an introduction it may be commented that, whatever policies may say, there are severe practical difficulties in dealing with the aftermath of an earthquake. One is that the sheer volume of claims may make claims-investigation and subsequent claims-handling a matter of some difficulty. There are only limited numbers of loss adjusters and claims handlers. The English and Scottish Law Commissions proposed in a Consultation Paper issued in December 2011 that insurers should be under a duty close to that recognised in Australia under the continuing duty of utmost good faith[6] to investigate and pay a claim within a reasonable time, and there is some debate as to whether that is or is not the existing common law position.[7] Assuming that there is such a duty, how would it respond to a situation in which it is just impossible for all claims to be processed speedily? This is of particular importance where reinsurers are involved, a point expanded below.

A second difficulty is that insurers generally have the option to reinstate premises rather than to pay the repair costs, and that option is frequently exercised. However, construction projects cannot go ahead without the relevant first and third party property insurances which constitute construction all risks cover, and, at least for a time in New Zealand, such policies became, to say the least, scarce by reason of the continuing earthquakes and aftershocks.

6 Insurance Contracts Act 1984 (Cth), s 13.

7 The prevailing view in England is that the insurers are under a duty to hold the assured harmless, so that they are in immediate breach of contract and liable for damages as soon as the loss occurs. That in turn means that there cannot be any obligation to pay damages for late payment, as that is tantamount to an award of damages on damages: see *Sprung v Royal Insurance* [1999] 1 Lloyd's Rep IR 111. It is uncertain whether the same rule applies in New Zealand, and it may also be that New Zealand has not accepted the prohibition on the awarding of compound interest recognised in England. See Chris Nicoll, "Compound Interest for Late Payment of an Insurance Claim" (2008) 124 LQR 199.

That apart, the supply of builders and other tradesmen to carry out the necessary work after any disaster is always restricted. So the practicalities of reinstatement are far more complex than any policy wording might indicate.

B. Insurance Coverage

Coverage for damage to land, buildings and contents caused by earthquakes is provided under a statutory scheme in New Zealand, but only for residential buildings insured privately against fire. The Earthquake and War Damage Act 1944, which developed from the scheme of compulsory insurance for war damage introduced in New Zealand in 1941 (based upon the UK's War Damage Act 1941), laid the foundations for the present scheme. The governing legislation is now the Earthquake Commission Act 1993,[8] supplemented by the Earthquake Commission Regulations 1993.[9] The 1993 Act removed war damage from the list of compulsory perils, but extended the scheme to other natural disasters, namely: natural landslip, volcanic eruption, hydrothermal activity, tsunami, storm or flood; in the case of residential land only, storm or flood; and any fire consequential upon another natural disaster.[10] The Earthquake Commission (EQC) first established by the 1944 Act, owes its statutory existence to Part 1 of the 1993 Act. The EQC is a Crown entity governed by a Board,[11] although subject to ministerial direction,[12] and its function is to administer the compulsory insurance regime.[13]

In outline, a person obtaining fire insurance on residential buildings[14] is "deemed" to be covered by EQC. There is no contractual relationship between the assured and the EQC, which means that the arrangement is not a contract of insurance as such but rather a statutory arrangement, so that the protective measures in respect of insurance contracts contained in the Insurance Law Reform Act 1977 (for example against forfeiture in the event of a late claim) have no application.[15] The "deemed" insurance applies to three different forms of loss. The first is against natural disaster damage to

8 Earthquake Commision Act 1993 [1993 Act], as amended.

9 Earthquake Commission Regulations1993 See review comment), as amended.

10 1993 Act, above n 8, s 1, which also defines the various perils here identified.

11 Ibid, ss 4-4A.

12 Ibid, s 12.

13 Ibid, s 5.

14 Defined by s 1 as a building at least 50 per cent of which is used for residential purposes, so that small businesses operated from premises which also contain a dwelling are not necessarily protected. Rest homes are covered, as are apartments within hotels. There are some disputes concerning flats above shops The EQC has issued guidelines to resolve borderline disputes, but these have no legal status as such and are open to challenge. See Morley v Earthquake Commission [2013] NZHC 230 (boarding houses are "dwellings").

15 *AMP Fire and General Insurance Company (NZ) Ltd v Earthquake and War Damage Commission* (1983) 2 ANZ Ins Cas 78,016; *Earthquake and War Damage Commission v Waitaki International Ltd* [1992] 1 NZLR 513; *Earthquake Commission v Disputes Tribunal* [1997] NZAR 115; *Coughlan v Earthquake Commission* [2007] NZHC 178. Equally, EQC is not a member of the voluntary Insurance and Savings Ombudsman, set up to resolve disputes between insurers and consumers.

the buildings themselves, for their replacement value.[16] The sum recoverable[17] is based on the terms of the fire policy, and is the lesser of: any specified replacement sum; if there is no replacement sum specified, the sum insured, although that sum may not be less than NZD 1,000 per square metre; or, in the case of a building with more than one dwelling, NZD 100,000 for each dwelling disclosed to the insurers prior to the making of the contract. A per dwelling excess of NZD 200 has to be borne for all damage occurring within any one 48 hour period (7days in the case of fire).[18] The second is against damage to residential land, consisting of the total of the value of that portion of the site which exceeds the minimum allowable size at the date of the damage plus, bridges, culverts and retaining walls which are necessary for the support of the building,[19] subject to a per dwelling excess of NZD 500 or 10 per cent of the value of the land, capped at NZD 5000. Thirdly, there is coverage for personal property, excluding property wholly or mainly used for business purposes, for its replacement value, being the lesser of the maximum sum insured or NZD 20,000,[20] subject to an excess of NZD 200. The deemed insured sums are low, and are based on 1994 values, the effect of inflation being that the cover is something around 50 per cent in real terms of the 1994 figure. Assureds will typically take out their own insurance on buildings and contents, although not the land itself. Typically, therefore, the value of the land, or at least a small part of it, is covered by the EQC, and the cost of repairing the buildings is taken up by the EQC, with any balance above NZD 100,000 falling to private insurers.

The 1993 Act will treat any other insurance as primary layer cover unless the policy otherwise provides;[21] unsurprisingly it is standard practice for buildings and contents policies to be framed as excess layer cover to that provided by statute. The Act provides for automatic reinstatement of cover within the policy period,[22] and consecutive losses are payable in full unless the EQC has, on payment, cancelled future cover.[23] Additional premium is payable on reinstatement.[24]

The compulsory insurance does not extend to: intangible property; motor vehicles; trailers; vessels; aircraft; plants and growing crops; explosives; animals; roads, paths and bridges not an integral part of the building; drains; dams; swimming pools; tennis courts; jetties; artificial services; and jewellery, precious stones, money, works of art, securities, documents, or stamps.[25]

16 1993 Act, above n 8, s 18.
17 In all cases, plus 15 per cent GST.
18 1993 Act, above n 8, sch 3, para 1; 1994 Regulations, above n 9, reg 4.
19 1993 Act, ibid, s 19. The definitions are contained in s 1. It was held in *Earthquake Commission v Winch* [2008] NZHC 1721 that the land includes a right of way over neighbouring land which does not belong to the applicant himself.
20 Ibid, s 20.
21 Ibid, s 30.
22 Ibid, sch 3, para 6. See below.
23 Ibid, sch 3, paras 4-5.
24 Calculated in accordance with the formula in the 1994 Regulations, above n 9, reg 5.
25 1993 Act, above n 8, s 21 and sch 2.

There is no coverage if the building has been constructed under a building certificate which states that the land is prone to a particular form of loss and such loss occurs as the result of a natural disaster.[26] In addition, if the Act does apply, claims cannot be made for consequential loss.[27] If there is no fire policy in place then there is no automatic insurance of the statutory risks, although application may be made to EQA for direct cover against those forms of loss.[28]

Payment for this cover is in the form of a compulsory levy on the premium payable under the fire policy.[29] The levy is no more than an arbitrary representation of the cost of earthquake cover premium, presently 15 cents (raised from 5 cents in February 2012) for every NZD 100 insured.[30] An actuarially calculated premium for land damage has been estimated as at least three-times that figure, although even that is likely to be an understatement given that the scale of losses from an earthquake is not predictable given their rarity and varied intensity, and indeed most of the loss from the 22 February 2011 earthquake was the result of liquefaction, a form of casualty which had not been anticipated.

The levy is received by fire insurers as a debt from the assured, and they operate for this purpose as "volunteer" tax collectors, being required to pay over the premium to the EQC within two months from the end of the month of receipt.[31] The proceeds of the levy are held in the Natural Disaster Fund. Claims may be made by any deemed assured with an insurable interest against the Fund in respect of any actual or imminent physical loss or damage to residential property occurring as the direct result of a natural disaster or of measures taken by public authorities to mitigate the consequences of a natural disaster. The EQC may, at its discretion, settle a claim up to the limit of indemnity by payment, replacement or reinstatement,[32] and it must do so as soon as reasonably practicable and in any event within a year after the amount of damage has been determined.[33] If necessary, buildings can be relocated on the same or even a different site.[34]

The Natural Disaster Fund is backed by both private reinsurance written in the international reinsurance markets, and by a Government guarantee which applies in the event that the Fund and the reinsurance are exhausted. Immediately before the earthquake on 4 September 2010 the Fund stood

26 See *Doyle v Earthquake Commission* 2009 HCNZ WHA Civ 2008-488-000563, where the loss was not of a type certified so that the claim succeeded.

27 1993 Act, above n 8, sch 3, para 2.

28 Ibid, s 22.

29 Ibid, s 23.

30 1994 Regulations, above n 9, reg 3.

31 1993 Act, above n 8, s 24.

32 But only as circumstances permit and in a reasonably sufficient manner: ibid, sch 3 , para 9.

33 Ibid, s 29.

34 1994 Regulations, above n 9, reg 10.

at NZD 5.9 billion.[35] Reinsurance coverage of NZD 2.5 billion is, subject to a deductible of NZD 1.5 billion, available for losses caused by any one earthquake, and once the reinsurance coverage is exhausted the EQC is to dip into its Fund reserves. Only after that is the State guarantee to be called into place. The first earthquake led to claims up to NZD 3.5 billion, requiring the fund to pay the first NZD 1.5 billion, with the balance recoverable from reinsurers. That left some NZD 4.4 billion in the pot. The second earthquake is expected to reduce the Fund by a further NZD 1 billion.[36] Earthquake Recovery Minister Gerry Brownlee, in a television interview on NZ TV One on 24 February 2011, estimated that there would be 180,000 claims against the EQC from the first earthquake and a further 150,000 in respect of the second, but that many of the claims overlapped.[37] In practice there has been some delay in EQC settlements, given disputes over the applicability and amount of the cover.

As noted above, domestic dwelling owners are protected by EQCover only if they have private fire insurance. Such insurance is by definition restricted to buildings, whereas EQCover extends to the land itself. Commercial premises fall outside the EQCover Scheme, and any protection can be by private insurance only. The EQC also excludes bare land and buildings under construction which are protected by works insurance but not fire cover. In the event of a natural catastrophe, therefore, the international reinsurance markets will potentially experience substantial major claims from the EQC, from the general insurance market in respect of excess layer cover for damage to residential premises and contents, and from the general insurance market alone in respect of damage to commercial premises.

35 But there are issues as to just how much of this was "real" money. It seems that about NZD 1.5 billion was in offshore equities, some NZD 300 million-NZD 400 million was working capital in bank bills and the remaining NZD 4 billion was in the form of non-tradable government bonds, the latter sum disappearing in consolidated government accounts. See the EQC Chairman's Report of 4 September 2010, just before the first earthquake: "But as more than $4 billion of the Fund is in New Zealand Government securities, the Government will be faced with finding cash to redeem these once claims on EQC exceed around $4.3 billion." So it may be that the real figure is about NZD 1.9 billion.

36 This assumes that there are two separate claims against the reinsurers, although that is almost certainly the case on the wordings used. See below.

37 The evidence of the EQC itself in *Tower Insurance Ltd v Earthquake Commission* [2011] NZHC 943 referred to 313,000 claims from the two earthquakes, although 110,000 properties had multiple claims from both earthquakes.

II. Property Claims[38]

A. Is There a Loss in the Red Zone?

The initial question in any property claim is whether there is a loss at all. The point is of particular significance in respect of Red Zone properties and CERA buy-out. As indicated earlier, as part of its role for co-ordinating the rebuilding and regeneration of the damaged area, CERA is authorised, on behalf of the Crown, to buy out landowners in the Red Zone based on the valuation of the land and buildings.[39] The relationship between the buy-out offer and any insurance coverage is set out in detail on the CERA website. The owner has two options. The first is to transfer to the Crown the land and the buildings, together with all insurance claims against EQC and private insurers: depending upon the circumstances, the amount paid by the Crown may be greater or lesser than the sums recoverable from the insurers. Where there has been EQC payment before the sale, that amount is deducted from the sum payable by the Crown. The second is for the assured to remain in possession but to allow the Crown to take over any claims against the EQC for damage to land, and any difference between the value of the land and the amount recoverable from the EQC is topped up by the Crown. That leaves the assured to recover what he can from his buildings insurers, which – as seen below – may be nothing, so the second option is all but illusory. If there has been a settlement with insurers for a total loss, then either option is available before the CERA offer letter is received, but only the second option can be exercised after receipt of the CERA offer letter. In either case insurance claims for contents, stress, alternative accommodation, moving, and the like – that is, those unrelated to the land itself – are retained by the landowner.

All of this begs the question whether there is any loss at all, for insurance purposes, of a Red Zone property which has not suffered substantial structural damage.[40] Insurance law recognises that there has been an actual loss of property where: (a) it has ceased to exist in its entirety; or (b) the assured has been irretrievably deprived of possession.[41] Marine insurance is more generous, and deems property which is damaged beyond economic repair or which is unlikely to be restored to the assured within a reasonable time to be a constructive total loss, the assured thereby being given the option[42] to treat

38 In the wake of the earthquakes, private insurance on buildings and contents has been hard to find. Some insurers have indicated that they will not renew or issue new policies unless a period of two months elapses between major earthquake events. Of course, if private insurance is unavailable then EQC cover is also removed, as it is parasitic on private cover for residential premises.

39 Compulsory purchase is a fallback possibility if the majority accept and only a few remain, but the price payable will be significantly lower than for a voluntary acceptance.

40 The point is analysed in detail by Duncan Webb in a legal opinion dated 17 April 2012 for Lianne Dalziel MP, available online at <www.scoop.co.nz>.

41 Marine Insurance Act 1908, s 57.

42 Which is only rarely refused.

the loss as a total loss and to recover the full sum insured.[43] Non-marine law does not recognise these extended concepts, so if there is to be any recovery under the policy it will be necessary to show a total loss by deprivation. If there is compulsory purchase then there is little difficulty in holding that there has been an actual total loss by deprivation even in the absence of significant damage. However, there are two important caveats. The first is that many property policies define loss only in terms of physical destruction and not deprivation. The second is that even if deprivation is an insured risk, CERA offers are not of compulsory purchase as such, although the reality is that CERA offers are rarely rejected, for the practical reasons that building consent for repair within the Red Zone will not be granted, local services and amenities will not be restored or may be discontinued, future insurance is not going to be easy to obtain and CERA does have compulsory insurance powers which may produce a lower price than that under the Crown offer.

So, it is necessary to ascertain whether there is an insurance claim where a CERA buy-out offer of a lightly damaged or undamaged property is accepted. There would appear to be a distinction here between "loss" and "damage". Loss is seemingly confined to deprivation or total destruction. "Damage", by contrast, is a wider concept, and the authorities suggest that any sort of physical effect on property which renders it less valuable is "damage" for insurance purposes.[44]

However, if cover is confined to "physical damage" the matter becomes more complex, because it is clear from the authorities that property which merely diminishes in value, or which is unable to perform its functions, is not physically damaged at all. Such loss is purely economic and is irrecoverable both in tort and also under insurance policies.[45] It has been argued that there might be a distinction between "damage" and "physical damage", the former being a wider concept,[46] and if that is right then the outcome in any one case rests upon the fortuity of the wording used.[47]

43 Marine Insurance Act 1908, s 60.

44 *Ranicar v Frigmobile Pty Ltd* [1983] Tas.R. 113*; Bayer Australia Ltd v Kemcon Pty Ltd* (1991) 6 ANZ Insurance Cases 61-026; *Cedenco Foods Ltd v State Insurance* (1997) 6 NZBLC 102,220*; Switzerland Insurance Australia Ltd v Dundean Distributors Pty Ltd* [1998] 4 VR 692; *Bridgeman v Allied Mutual Insurance Ltd* (1999) 10 ANZ Insurance Cases 61-448;*Technology Holdings Ltd v IAG NZ Ltd* (2009) 15 ANZ Ins Cas 61-786; *Jan de Nul (UK) Ltd v Axa Royale Belge* [2002] 1 Lloyd's Rep 583.

45 Copious citation authority is unnecessary, and it here suffices to refer to *Horbury Building Systems Ltd v Hampden Insurance* [2007] Lloyd's Rep IR 247 in which both issues are addressed in the context of a product liability policy. See Webb, above n 40, at [68].

46 Webb, above n 40, at [59-60].

47 That sort of approach did not appeal to the UK Supreme Court in *Employers' Liability Insurance "Trigger" Litigation: BAI (Run Off) Ltd v Durham* [2012] UKSC 14.

B. Trapped Subject Matter

The issue here might arise, in for example, the case of a collapsed or inaccessible building which contains valuable goods, whether assets or business records, which are not totally destroyed but which cannot be retrieved either through physical impossibility or by reason of restrictions imposed by public authorities. There are English cases which show that if the subject matter has been seized or gone missing, but it cannot be confirmed that the subject matter has been permanently taken, then there is no loss at all for insurance purposes.[48] Equally, there is no loss if there is no physical change to the subject matter but it has for other reasons become of reduced value to the assured.[49] There is, however, a useful straw in the wind for policyholders. In *Masefield v Amlin Corporate Member Ltd*,[50] in which it was held that there was no loss of cargo seized by pirates because it was all but inevitable that a ransom would be paid allowing the cargo to be released, Rix LJ commented that the marine definition of actual total loss was a narrow one, given that the assured is entitled to recover for constructive total loss where it is not likely that the subject matter will be recovered within a reasonable time, and accordingly that a more generous interpretation might apply in non-marine cases. If that is right, there is a plausible claim for actual total loss in respect of subject matter which is trapped but with uncertain prospect of retrieval.

C. Consecutive Losses: Merger

Many policies on commercial premises provide for automatic reinstatement of cover unless, following a loss, the insurers give notice to the contrary. The effect is that, once cover has been exhausted, the assured is entitled to further cover on payment (or accepting liability for payment) of the amount of the original agreed premium, so that consecutive losses remain recoverable.[51] Other policies, and in particular domestic insurances, do not provide for automatic reinstatement but provide cover on a "per occurrence" or "per happening" basis, so that the policy moneys are fully available for each loss. There has been a particular problem with regard to properties damaged in the 4 September 2010 earthquake and again in the 22 February 2011 earthquake where a single policy was in place for a period covering both of these dates.

48 *Moore v Evans* [1918] AC 185; *Holmes v Payne* [1930] 2 KB 301 *Scott v Copenhagen Reinsurance Co (UK) Ltd* [2003] Lloyd's Rep IR 696. Fortunately, motor insurers take a more benevolent view in the case of stolen cars, allowing claims for total loss after a respectable period had elapsed even though there is a likelihood that the car will be found sooner or later.

49 *Re Mining Technologies Australia Pty Ltd* (1999) 1 Qd R 60. Contrast *Ranicar v Frigmobile Pty Ltd* (1983) 2 ANZ Ins Cas 60-525, where there had been a physical change to the subject matter, leading to a depreciation in its value, so there was recovery.

50 *Masefield v Amlin Corporate Member Ltd* [2010] EWCA Civ 24.

51 Clauses differ significantly in wording. In a number, policy reinstatement occurs on the claim being met by payment or repair.

The simplest case is that in which buildings damaged from the first earthquake have been repaired using the policy moneys. If there is automatic reinstatement of the sum insured then, unless the insurers have cancelled cover, the assured can recover again for the damage caused by the second earthquake. That is as it should be, because the assured has paid a second premium and is in effect facing a fresh risk. Equally, a policy which covers occurrences or happenings will respond in the same way, as there are consecutive triggers of cover.

A further scenario arises in respect of policies which were renewed between earthquakes, leaving unrepaired damage at the end of the first policy period. The assured is entitled to be paid for that loss even though the property is completely destroyed by a later earthquake, on the principle that the assured has suffered a loss for which insurance proceeds are payable and what happens (or does not happen) thereafter is entirely irrelevant.[52] The assured can thus recover under the first policy, and he may also recover for whatever additional loss has occurred in the period of the second policy.

However, matters are more complex if there is only a single policy involved and two or more losses occur in the period of cover, the earlier of which are unrepaired. Let it be supposed that the assured has either not been paid for damage caused to the buildings by the first earthquake, or has been paid but has not repaired that damage, and further damage is inflicted by the second earthquake. It seems all but obvious that the assured should not be able to recover both the amount necessary to make good the first loss and then the full reinstatement cost of the buildings from the condition that they have reached following the second loss. In the marine insurance market, this would be the effect of the doctrine of merger. Section 77(2) of the Marine Insurance Act 1908 provides that an unrepaired partial loss merges into a subsequent total loss in the same policy year, so that an assured who has suffered an unrepaired partial loss cannot claim both for that and for the later total loss, as that outcome would be contrary to the principle of indemnity.[53] The underlying indemnity principle is further illustrated by the interpretation of s 77(1) of the Marine Insurance Act 1908 in *Kusel v Atkin*, *The Catariba*. [54] The subsection codifies the common law rule that the assured is entitled to recover for a series of partial losses even though in aggregate the amount payable exceeds the maximum policy limits, although it is often ousted in practice.[55] In *Kusel* the vessel suffered a partial loss which was left unrepaired, and then suffered a further partial loss which, if paid in full, would have allowed recovery in excess of annual policy limits. The court ruled that the principle in s 77(1) applied only to repaired partial losses, so that – unless

52 *Coles v Hetherton* [2012] EWHC 1599 (Comm).

53 *Livie v Jansson* (1810) 12 East 648; *British and Foreign Insurance Co Ltd v Wilson Shipping Co Ltd* [1921] 1 AC 188.

54 *Kusel v Atkin*, *The Catariba* [1997] 2 Lloyd's Rep 749.

55 In the form of a clause which states that the sum insured under the policy applies to any one loss *and in the aggregate*.

there is express provision to the contrary – the notion that an assured is entitled to aggregate partial losses and to recover for them all even if the total exceeds the maximum sum insured[56] has no application to unrepaired losses. Damage from the first partial loss is in effect regarded as having merged into the subsequent loss. Two questions flow from the merger principle: does s 77(2) apply to non-marine insurance; and does either automatic reinstatement or per occurrence indemnities affect the position?

Turning first to the operation of merger in non-marine insurance, it has generally been assumed that marine and non-marine insurance operate on the same basis, and there are dicta to that effect.[57] However, in *Ridgecrest NZ Ltd v IAG New Zealand Ltd*[58] Dobson J held that the merger principle had no application to non-marine policies. In *Ridgecrest* itself, the assured's building had been damaged in two earthquake events, and partially repaired, before becoming a total loss from third and fourth earthquakes. The assured sought the full amount of the unpaid repair costs for the first two earthquakes as well as the full sum insured on total loss.[59] Dobson J dismissed the claim for reasons discussed below, but not on the basis of merger. The court ruled that marine and non-marine insurance differed in two respects: marine insurers were liable for damage to the insured vessel only when the policy came to an end, so that losses had to be measured at that date; and a marine policy contemplated that marine insurers were not concerned with damage occurring after the vessel had become a constructive total loss because the vessel was to be abandoned to them on that event. By contrast, in the non-marine market, the insurers are liable for the loss as soon as it occurs, and the insurers remain liable for damage occurring after a total loss in circumstances where the building has been repaired. It is submitted that neither of these distinctions is supported by authority. It is settled law that a marine insurer's liability to make payment arises on the date of the insured peril and not at the end of the policy year, a principle borne out by the running of the limitation period, the unavailability of damages for late payment because damages become owing on the date of the peril[60] and – in the case of a constructive total loss – the right of the assured to recover for that loss irrespective of the fact that the vessel becomes an actual total loss from an uninsured peril immediately thereafter and before the policy has expired.[61] The only significance of the termination of the policy is that it brings an end to the doctrine of merger, so that post termination losses are to be disregarded in fixing the right of the assured to recover under the expired policy for unrepaired losses.[62] The further suggestion that there

56 Marine Insurance Act 1908, s 77(1).
57 *Wright, Stephenson, and Co Ltd v Holmes* [1932] NZLR 815.
58 *Ridgecrest NZ Ltd v IAG New Zealand Ltd* [2012] NZHC 2954.
59 The building was underinsured, so the assured was not seeking to make a "profit" as such, only to recover his actual loss. That does not of course mean that he was entitled to such loss because he had paid a premium based on an underinsured value.
60 *Ventouris v Mountain, The Italian Express* [1992] 2 Lloyd's Rep 281.
61 *Kastor Navigation Co Ltd v AGF MAT* [2004] 2 Lloyd's Rep 119.
62 *Lidgett v Secretan* (1871) LR 6 CP 616.

is some distinction between marine and non-marine insurance following a total loss is also unsupportable: in each case the insurer has the right to take over the insured subject matter on payment for a total loss.[63] It is, therefore, submitted, that *Ridgecrest* is incorrect as a matter of principle, and that the doctrine of merger applies alike to marine and non-marine insurance unless it is ousted by agreement.

That point, therefore, gives rise to the second issue of whether merger – if it applies – is ousted by an automatic reinstatement provision triggered by payment of a further premium. Here, the marine analogy is not perfect because in that context a second premium will not have been paid. It might be argued that the effect of automatic reinstatement is to trigger fresh coverage, purchased by an additional premium, so it cannot be regarded as unjust enrichment for the assured to be able to recover the loss under the original cover and then the loss under the reinstated cover even if the earlier loss is unrepaired: the position is analogous to the termination of the first cover which, as noted above, brings an end to the possibility of merger.[64] The position is not the same, however, where the policy is written on a per occurrence happening. In *Ridgecres,t* Dobson J was of the view that "per happening" coverage would have ousted merger had it been applicable: it might be thought that the wording is not sufficiently clear to oust the indemnity principle and to allow the assured to recover for notional rather than actual losses.

Interestingly, the same point has been discussed by the High Court of New Zealand, although in the context of the coverage provided by the EQC, and the decision rests purely upon the construction of the legislation. The assumed scenario, and a common one, was that damage occurred to property as a result of the 4 September 2010 earthquake, and this had not been repaired by the date of the 22 February 2011 earthquake, at which point further damage was inflicted. In *Tower Insurance Ltd v Earthquake Commission*[65] private insurers offering cover in excess of EQC limits asserted that the statutory scheme provided a separate limit of indemnity for each of the claims, either because the maximum sum recoverable from the EQC applied to each loss during the period of the fire policy ("continuing cover") or because the maximum sum recoverable from the EQC was reduced by any claim and, on payment for the first damage, cover for the maximum sum was reinstated with retrospective effect back either to the date of the first damage or to the date on which a claim for the first damage was made ("retrospective reinstatement"). On either approach the liability of excess layer insurers would be postponed. For its part the EQC argued that there

63 Some confusion has admittedly been generated by the need for the assured under a marine policy to serve a notice of abandonment following a constructive total loss in order to claim indemnity measured by reference to a total loss, but it is now clear that there is a distinction between a formal notice of abandonment and the physical act of abandonment following a total loss: see *Kastor Navigation Co Ltd v AGF MAT* [2004] 2 Lloyd's Rep 119.

64 *Lidgett v Secretan* (1871) LR 6 CP 616.

65 *Tower Insurance Ltd v Earthquake Commission* [2011] NZHC 943.

was one limit of indemnity per policy period, and that its cover reinstated only on the renewal of the cover. That meant that any liabilities in excess of $100,000 in any one policy year were for the insurance market. The High Court rejected the EQC's case as inconsistent with the statutory requirement that cover was to continue to the same extent as before the natural disaster damage occurred and, although it did not need to choose between the other options, a preference was expressed for the "continuing cover" approach.

D. Reinstatement of Buildings: Frustration

Most property policies confer upon the insurers the option either to pay a sum representing the assured's loss (which may be the diminution in value of the damaged property or repair costs) or to rebuild (reinstate). *Ridgecrest* is typical of many cases where property was damaged in the 4 September 2010 earthquake and insurers opted to reinstate. Before they had done so, either at all or in full, the 22 February 2011 earthquake caused serious damage to the building or even rendered it a total loss. In *Ridgecrest* it was argued by the insurers, as an alternative to their failed merger point, that the rebuilding had been frustrated, thereby discharging the insurers from liability for the earlier losses and that the only remedy was recovery for the final earthquake. That approach was adopted by Dobson J. The court ruled that there was to be implied into the policy a term that, if repairs were rendered impossible by a later loss event, the obligation to repair would be frustrated. Were it otherwise, the assured could accumulate notional partial losses and recover for them as well as the ultimate total loss. Dobson J found support for his ruling in *Wright, Stephenson, and Co Ltd v Holmes*,[66] where insurers who had elected to repair a damaged vehicle were held to be discharged from their obligation to do so after it was destroyed by an uninsured event – an earthquake – before repairs could be effected. This is something of an unlucky result, and it may be that the doctrine of merger would have reached it by different means, but the point remains that the analysis does not stand up. Where insurers opt for reinstatement, they enter into a building contract to that effect. If they are prevented from reinstating, they are not discharged from liability; it is simply the case that the building contract is frustrated, thereby reviving the policy as it stood before the option to reinstate was chosen and leaving the insurers with a liability to pay for the damage. That means that a second loss event does not end liability under the policy; instead, it operates to merge the first loss into the second loss, leaving the insurers with an obligation to pay for a total loss if they occur in the same policy year. This analysis is important to remove the argument that if insurers opt to reinstate after the first earthquake, and the building is destroyed by the second earthquake, they face no liability all because the policy is frustrated by the first earthquake. What is frustrated is merely the obligation to rebuild.

66 *Wright, Stephenson, and Co Ltd v Holmes* [1932] NZLR 815.

E. Measure of Indemnity

A standard buildings policy will provide for repair costs, generally uncapped, with an alternative for insurers to reinstate. The approach of insurers varies from case to case. In some circumstances the insurers are content to allow the assured to control the repair work, simply paying bills. In others, where there is more serious damage, insurers take over the works, at which point the law treats them as having converted their obligations from insurers to builders. One important consequence of a decision to reinstate is that the duty of the insurers is to provide the assured with premises equivalent to those that were damaged or destroyed, and if that means that unforeseen events, including subsequent perils or delays, push up the costs of reinstatement beyond policy limits then that is a loss that insurers have to bear.[67]

In England most buildings policies are written "subject to average", so that in the event of partial loss the insurers' liability is reduced by the uninsured percentage as against actual value. Average clauses are viewed with disfavour, in that most assureds have no idea that the simple phrase "subject to average" can have dramatic implications where there is underinsurance. Accordingly, s 15 of the Insurance Law Reform Act 1985 renders void any average clause in a policy on a dwellinghouse (or part of a building used as a dwellinghouse) and its contents, and although average clauses are permitted in other policies they are ineffective unless, before the contract is entered into, "the insurer clearly informs the insured in writing of the nature and effect of the condition", the section providing a model form of wording. Average clauses appear not to be in widespread use in commercial policies, the result doubtless of both inertia given the statutory rules and of pressure from brokers. It may be commented in passing that CERA operates an "average" policy: If a property is underinsured by more than 20 per cent, the Crown's buy-out offer is reduced by the percentage of underinsurance.

Average aside, there are two other issues which have given rise to disputes about the appropriate measure of indemnity.

The first of those issues concerns the relationship between private insurance on buildings and EQCover on the land itself. Demarcation disputes have arisen where the damage to the land has given rise to additional building costs, each side asserting that those costs are for the other. This is a particularly acute issue, given that more extensive foundations are required on land which has been zoned. Insurers take the view that such work consists of land remediation rather than building repair.

67 *Brown v Royal Insurance Co* (1859) 1 E & E 853. In some cases the assured may be given the reinstatement option. See also TJK (NZ) Ltd v Mitsui Sumitomo Insurance Co Ltd [2013] NZHC 298, where the court construed a policy providing for full indemnity only after building costs had been spent by the assured as meaning that the assured was entitled to an indemnity based on loss of market value from the outset, with a full rebuilding indemnity payable once the costs had actually been incurred and the building reinstated.

The second issue is that of betterment. Where the land remains suitable to support rebuilding,[68] any rebuilding will almost certainly have to be undertaken to standards higher than those originally adopted, for it is commonplace for local authorities to demand that buildings damaged by earthquakes are rebuilt to an earthquake-proof specification that is generally higher than that which previously existed.[69] Providing the assured with a building which is of the requisite higher standard is plainly going to be more expensive than pure rebuilding cost. In one sense there is "betterment" for which a deduction can be made, in that the assured has received a better building than that which he previously owned. But in another sense, there is no betterment because it is not permissible as a matter of law for the buildingto be rebuilt to its previous standards, so that the assured is only getting what he had before, that is something in which he can properly occupy.[70]

Whether such additional costs are recoverable depends upon the policy wording. Policies almost universally extend to those costs, subject to exceptions where the property failed to comply with the standards current when it was built or where the assured was required prior to the loss to upgrade the property but failed to do so. It would seem that most policies do cover the cost of compliance with whatever building regulations happen to be in force at the time. If the policy is silent, then it appears from *Lumley General Insurance Ltd v Vintex Pty Ltd*[71] that the court will recognise an obligation on insurers to rebuild to the new higher standard. Here, the assured's building in Newcastle, which housed several retail outlets, was severely damaged by an earthquake on 28 December 1989. The assured's policy covered loss caused by earthquake. The indemnity clause was in familiar form, requiring the insurers, at their option, either to pay the value of the property at the date of the loss, or to reinstate. The sum insured was AUD 4,950,000. The cost of reinstatement at the date of the earthquake had not been finally determined, although the insurers had paid on an interim basis and without prejudice the sum of AUD 2,500,000. However, by the time that rebuilding work had commenced the local authority had, through a new Earthquake Code, changed building requirements respecting earthquake protection, and the actual costs of rebuilding to the new standard were increased by some AUD 231,000. The action was brought for that additional sum. The Supreme

68 If it does not, some policies permit rebuilding at another location. That raises the question of the nature of the building to be erected in the new location. Is the assured entitled to an equivalent? All will turn upon policy wordings.

69 The legality of the imposition of the requirement for higher building standards, requiring an earthquake strengthening to a 67 per cent standard, is the subject of separate disputes. See Insurance Council of NZ Inc v Christchurch City Council [2013]NZHC 51 (round one to the insurers).

70 Betterment is not a new issue in New Zealand. It has arisen recently in the context of "leaky houses", an epidemic of claims for properties which were poorly designed and which have to be repaired to a standard higher than that originally adopted. The story is one for another day. See the official NZ government website, <www.dbh.govt.nz>. See, eg, Turvey Trustee Ltd v Southern Response Earthquake Services Ltd [2012] NZHC 3344.

71 *Lumley General Insurance Ltd v Vintex Pty Ltd* (1991) 24 NSWLR 652.

Court of New South Wales unanimously awarded that sum to the assured. Mahoney JA felt that insurers would be discharged from providing a full indemnity only where the post-loss change rendered the policy inapplicable, where the building took a completely new form or where the assured obtained a better building, but there had not been evidence of any of these matters in the present case. Meagher J regarded the insurers' objections as "unreal and harsh" and held that the assured was entitled to recover the actual rather than notional costs of rebuilding. Clarke J, in agreement with the further reasoning of Meagher J, rested his decision on the point that the reasonable expectations of the parties would be that insurers would pay for the cost of rebuilding to the new required standard.

It would seem, therefore, that the usual rule that the assured is entitled to recover the difference between the value of the subject matter immediately before and immediately after the occurrence of an insured peril has to be modified, in the case of rebuilding costs, in two respects. First, it is permissible to account for later developments which occur within the period within which it was reasonable to commence reinstatement[72] and which affect the rebuilding even though the insurers have not opted to reinstate but rather to pay for the cost of repairs. Secondly, the assured is entitled to be paid the full amount – up to policy limits – of the cost of restoring his building to its former glories, even though the rebuilding standard is higher, so that betterment has no application where the assured is simply recovering what he thought he had previously.

Whatever the measure of indemnity may be, the reality is that insurance frequently does not come close to compensating for actual losses. Persons evacuated from the Red Zone have to a large extent been bought out by the EQC on payment for the rateable value of the land and the replacement value of the dwelling (if a total loss) but the costs of relocating to other areas is not covered by the EQC and on occasion it may not be covered by private insurance. The western part of Christchurch was more expensive before the earthquake, but the mass migration has increased demand and thus escalated property values both in that area and also in the comparatively cheaper outlying areas, so Red Zone victims are likely to have to trade down even with full payment for land and buildings by the EQC and insurers. But, as is well known, property policies do not cover consequential losses of these types.

F. Allocation of Losses

A single person may own a number of buildings within the same vicinity. Insurance of such buildings may be on an individual basis, but it is perhaps more common for the owner to obtain a portfolio policy under which the buildings are insured under a separate contract. The total premium will be calculated by aggregating the value of all of the buildings in the portfolio,

72 A qualification adopted by Meagher J and Clarke J in *Lumley v Vintex*.

and such a policy will generally have appended to it a schedule of properties specifying the value of each. New properties may be added by declaration and payment of additional premium.

Problems have arisen in the New Zealand context by a combination of two factors: underinsurance; and failure by the policy to specify that it insures each building separately. To take a simple example, let it be supposed that 10 buildings of varying value, but in total NZD 40 million, are insured for the sum of NZD 20 million, and that one building accounts for 50 per cent of the total value but the remaining nine are smaller and are together worth only 50 per cent of the total value. If the prime building is destroyed, there is an immediate issue as to whether the assured can recover 50 per cent of the NZD 20 million sum insured or whether the assured is entitled to claim the full NZD 20 million on the basis that there is just a single risk rather than 10 separate risks. This is at root a question of contract construction. Doubtless the most obvious construction of a policy which incorporates a schedule of values would be that a proportionate part of the cover extends to each building, so that the recovery on the above facts would be NZD 10 million. However, careless preparation could mean that the only schedule of values appears in the proposal and is not incorporated into the policy so that it reads as one covering NZD 20 million for losses to any of the buildings.[73]

Some assistance may be derived from s 72 of the Marine Insurance Act 1908:

> 72.—(1) Where different species of property are insured under a single valuation, the valuation must be apportioned over the different species in proportion to their respective insurable values, as in the case of an unvalued policy. The insured value of any part of a species is such proportion of the total insured value of the same as the insurable value of the part bears to the insurable value of the whole, ascertained in both cases as provided by this Act.

This wording refers to different "species" and is concerned with a variety of cargoes insured under a single contract, and the assumption is that the assured can recover only that proportion of the insured sum as represented by the lost class of cargo. So, where there are different species, apportionment is the default. But, if all of the property is of the same class, there does not appear to be any assumption about apportionment. Matters are further confused by s 76(1) of the 1908 Act, which adds that if the policy covers total

73 It is understood that, at least in some cases, a rectification argument is to be used by insurers, asserting that the intention was to allocate losses and not to allow the assured full recovery for only a proportionate loss. In most cases, however, the market appears to have accepted settlements in favour of assureds, probably on a contra proferentem basis.

losses only[74] then the assured cannot recover for the total loss of a part of the subject matter unless the part totally lost is severable. Whether or not it is severable is a matter for the construction of the contract.[75]

Allocation of losses within and between contracts is a matter which has recently come to the fore in reinsurance litigation in England, although the question has not been "what" but rather, "when". The underlying issue is whether the reinsured is entitled to maximise recovery by adopting the allocation of losses most favourable to him or whether there is some form of good faith restraint on such conduct, although the courts have evaded answering that difficult question by confining themselves to contract terms.[76] The decisions thus far confirm that if the reinsured has suffered a series of losses which spread across policy years but the precise dates of those losses cannot be ascertained, there is some form of "presumption of symmetry" whereby losses are to be allocated to the period of cover. In *Municipal Mutual Insurance v Sea Insurance*[77] pilferage losses for which the reinsured was responsible occurred within an 18 month period representing the last three months of an expiring policy, the full extent of the subsequent policy and the first three months of a new policy. The Court of Appeal refused to allow the reinsured to treat all of the losses as occurring in a single year, thereby preventing the reinsured from adding the losses together so that the aggregate sum exceeded the level at which reinsurance cover attached in the chosen year. Instead, the losses were to be assumed to have occurred at regular intervals, so that they could be apportioned across the 18 month period of cover. It could be argued by an analogy – the strength of which would vary depending upon which side of the argument was being pressed – that there is an assumption that apportionable losses are to be apportioned and not aggregated.

III. Business Interruption Claims

A. The Nature of Business Interruption Policies

In order to demonstrate the effects of the earthquakes on business interruption (BI) policies, it is necessary to examine briefly how those policies work.

74 Or, to use the archaic and now redundant words of the legislation, is "warranted free from particular average".

75 Compare *Duff* v *Mackenzie* (1857) 3 CBNS 16, *Wilkinson* v *Hyde* (1858) 3 CBNS 30, *General Insurance Co Ltd of Trieste* v. *Royal Exchange Assurance* (1897) 2 Com Cas 144 and *La Fabrique de Produits Chimiques SA* v *Large* [1923] 1 KB 203 (apportionable) with *Hills* v *London Assurance Corporation* (1839) 5 M & W 569; *Ralli* v *Janson* (1856) 6 E & B 422; *Entwisle* v *Ellis* (1857) 2 H & N 549 (non apportionable).

76 See *Teal Assurance Co Ltd v W R Berkley Insurance (Europe) Ltd* [2011] EWCA Civ 1570.

77 *Municipal Mutual Insurance v Sea Insurance* [1998] Lloyd's Rep IR 421. See also *IRB Brasil Resseguros SA v CX Reinsurance Company Ltd* [2010] EWHC 974 (Comm).

The trigger for BI cover is the occurrence of some form of external peril. The most common form of peril is material damage to the premises from which the business is conducted. So, typically, BI insurance is not stand-alone, and rests upon the assured being able to make a property damage claim. However, there may be other trigger perils designed for particular forms of activity or for particular regions. Hotels and other premises may be insured against BI losses following the outbreak of disease which either prevents or inhibits tourists.[78] Other triggers may be – and these are found in many New Zealand policies – damage not to the assured's own premises but to the vicinity where the premises are located, or acts of civil authorities including prevention of access. These further triggers may, however, be subject to policy limits, eg, that only 5 per cent-10 per cent[79] of the total BI loss recoverable following material damage is payable in respect of BI loss flowing from location or civil authority triggers.[80] Once the existence of the external trigger is demonstrated, the assured must then prove that there was the necessary causal link between the trigger and the BI losses which have been incurred, and that causation test may, depending upon the policy, be more restrictive than the usual proximate cause doctrine, ie, the policy may specify that the BI loss must be "solely" or "directly" caused by the trigger.

Once the trigger and the appropriate causal link have been established, attention focuses on the amount recoverable. The starting point here is determining an "indemnity period" during which loss may be anticipated following the trigger event. The duration of the indemnity period rests upon what is agreed between the parties, and may range from months to years. Many New Zealand policyholders have found that the agreed indemnity period was too short for all losses to be recouped, but that is a matter of contract and no particular issues of law arise from it. As far as the calculation of the loss in the indemnity period is concerned, the assured is generally entitled to recover lost revenue in that period, deducting anticipated operating expenses and actual receipts from "standard gross revenue". The amount of standard gross revenue is typically based on the trading period immediately prior to the occurrence of the trigger event. Thus, in the case of a hotel with an indemnity period of

78 For a recent illustration from Hong Kong, see *New World Harbourview Hotel Co Ltd v Ace Insurance Ltd* [2012] HKCFA 21.

79 The normal range in New Zealand.

80 Thereby raising the question of whether the triggers are independent or concurrent. It is a matter of policy wording whether an assured facing both vicinity damage and authority action but not material damage can recover 10 per cent or 20 per cent of his loss in the indemnity period.

one year from the date of the trigger peril (for example, a fire), the amount recoverable will be based on the amount earned in the year immediately before the fire.[81]

It is recognised, however, that there may be other factors which have to be taken into consideration affecting both the comparator period and the indemnity period. The comparator period may have been particularly bad for business, or indeed particularly good for business, and the results in that year might have been artificially depressed or raised, as the case may be. The indemnity period might also, but for the fire, have been particularly good or bad for external reasons. Imagine, for example, a factory which, shortly before the trigger fire, installed new machinery which would have enabled a significant expansion in output to meet increased demand; plainly, a strict comparison with the period before the fire disregards the investment and understates the loss. For that reason policies generally contain a "trends" clause as part of the definition of gross revenue, of which the following wording is typical:

> The Gross Revenue during that period in the twelve months immediately before the date of the incident which corresponds with the Indemnity Period to which such adjustments shall be made as may be necessary to provide for the trend of the Business and for variations in or other circumstances affecting the Business either before or after the incident or which would have affected the Business had the incident not occurred, so that the figures thus adjusted shall represent as nearly as may be reasonably practicable the results which but for the incident would have been obtained during the relative period after the incident.

As may be seen from this wording, the starting point for the measurement of loss is the gross revenue earned in the comparator period, but allowing for adjustments in both the comparator period and the indemnity period. What is not obvious from the clause is which of its two parts is dominant. One view of the clause is that the operative words are "the figures thus adjusted shall represent as nearly as may be reasonably practicable the results which but for the incident would have been obtained during the relative period after the incident", so that the starting point is the provision of an indemnity and the comparator period is simply makeweight. The alternative interpretation is that the opening words "the twelve months immediately before the date of the incident which corresponds with the Indemnity Period" are to be given priority, so that the comparator period is all but conclusive of the lost revenue subject only to minor tweaks. Neither interpretation gives full weight to each part of the clause, but it might be thought that latter does less violence to the wording than the former, as the former in effect calls for the comparator period to be disregarded.

81 In some policies the indemnity period may be longer or shorter than the comparator period, and that can give rise to difficult issues of construction. Thus, in the case of a two year indemnity period but a one year comparator period, is the revenue in the comparator period to be applied to each of the years of the indemnity period separately, or is it to be assumed that there will be business development which allows greater recovery in the second year of the indemnity period?

B. Causation

Perhaps the most contentious matter arising out of the earthquakes is that of causation. Business premises are damaged by earthquake and rebuilding is essential. That means that the indemnity period begins to run from the date of the earthquake. However, the evacuation of the area on the instructions of the local authority means that, even if the premises had not been damaged by the earthquake, business interruption losses would have been suffered by reason of depopulation. Can it therefore be said that the BI losses are causally connected to material damage or merely to the action of authorities? The latter, if covered at all, is subject to a (say) 10 per cent sub-limit. The judgment which has been the most influential in resolving these matters is that of Hamblen J in *Orient-Express Hotels Ltd v Assicurazioni Generali SpA*.[82] This case is perhaps not as persuasive as it might be, for two important reasons. First, it was an appeal from an arbitration award and the English courts have been reluctant to overturn awards on the ground of error of law. A key part of Hamblen J's reasoning was indeed that as long as the arbitrators acted within permissible limits then they could not be said to have erred in law. In particular arbitrators under the English Arbitration Act 1996 have sole and exclusive jurisdiction to determine facts, so as long as the arbitrators have not erred in law then their application of the law to the facts cannot be challenged. Secondly, Hamblen J gave permission to appeal against his own decision, so he was plainly of the view that there was an important issue of law involved, but the parties settled the matter before the appeal was resolved. Those points aside, the decision is regarded as favourable for insurers.

The case concerned Hurricanes Katrina and Rita, which devastated large areas of New Orleans and its surrounds in August 2005. On 27 August 2005 a curfew was imposed and the City was evacuated on 28 August 2005. Re-occupation was permitted only at the beginning of October 2005. The assured operated a luxury hotel in the Central Business District of New Orleans. The hotel sustained significant physical damage from wind and water, and was closed throughout September and October 2005, opening on 1 November 2005. The policy provided BI coverage "against loss due to interruption or interference with the Business directly arising from [Material] Damage". The trends clause similarly stated that the assured could recover revenue which it would have obtained but for the occurrence of the insured peril. The assured's claim was that there had been material damage from the hurricanes, which gave rise to BI loss, so that the causation test in the policy had been satisfied. It was irrelevant that the vicinity had been closed by state action: at best the latter was a concurrent cause which was not excluded by the policy and therefore which did not affect the operation of the insured peril. The insurers' argument was that it was necessary to apply the usual tortious "but for" test, so that the assured could only recover that loss which it could show would not have occurred but for the physical damage. The arbitrators agreed with

82 *Orient-Express Hotels Ltd v Assicurazioni Generali SpA* [2010] EWHC 1186 (Comm).

the insurers. They proceeded on the basis that the assured had to show that BI losses were caused by physical damage. They ruled that the "but for" test required an assumption that the hotel had not been damaged but the vicinity had been closed. The question to be asked was, what would the revenue have been had there not been hurricane damage to the hotel? Applying that test, the arbitrators held that the assured would have suffered exactly the same interruption to its business even without any physical damage to the hotel, so it could not be said that it would have been able to carry on business in the usual way had the physical damage not occurred.

On appeal, the assured argued that the application of the "but for" test was inappropriate. It was accepted that "but for" was the governing principle. However, it was subject to an exception where fairness and reasonableness so required. Thus, where A and B independently and negligently were the cause of the same loss, the requirement that the loss would not have occurred "but for" the acts of either would exclude the liability of each of them, and it was appropriate to treat them as concurrently liable. Hamblen J expressed some sympathy with this approach but found it impossible to hold that the arbitrators had erred in law in applying "but for" on the facts before them. That was so for a number of reasons: (a) the "but for" test had been expressly adopted in the trends clause and was implicit in the policy itself; (b) it was not open to an appellate court to question whether the arbitrator's factual conclusion that disapplying the "but for test was not required in the interests of fairness and reasonableness;[83] (c) the suggestion that "but for" should not be applied on grounds of fairness and reasonableness had not been put to the arbitrators and could not therefore be raised as a ground for overturning the award; and (d) even if the decision could be challenged, it was far from obvious that fairness and reasonableness should overturn "but for" on the facts, as there was no sensible alternative – assuming an undamaged hotel in an undamaged vicinity would allow recovery for all BI losses however caused, assuming a damaged hotel in an undamaged city would have allowed the assured to recover losses flowing from damage to the city, and assuming a damaged hotel in a damaged city would lead to nil recovery.

What is apparent from this reasoning is that all turned on the policy wording and that the precise causation argument that the assured wished to raise was not one which was open to the court to consider. Further, even though the judge was sympathetic to an exception to "but for" on the facts, it could not be said that there was an error of law in failing to apply the exception; in effect the court was being asked to challenge a factual finding that it was not appropriate in the circumstances to disapply the "but for" test. All of this renders the decision a weak precedent, and it would be a matter

83 Section 69 of the Arbitration Act 1996 (England) permits a court to overturn an appeal only if the arbitrators have erred in law, and they cannot be said to have so erred if the point in question was not raised before them. The only situation in which a fresh point of law can be argued in an arbitration appeal is where the respondent argues that the award should be upheld on that alternative ground.

of some simplicity for a New Zealand court to dismiss the decision on the ground that it was largely the result of a strict application of the principle of non-intervention in the arbitral process. There is indeed much to be said for the argument that the problem raised in *Orient-Express* was straight causation. The assured's BI loss was proximately caused by hurricane, and further losses were inflicted by state action: there were two causes of loss, albeit consecutive rather than concurrent, and the usual rule that an insured peril takes precedent over an uninsured peril[84] should have prevailed. Indeed, the reasoning renders the primary cover[85] under BI policies of little value where a catastrophic event has affected both the assured's premises and the surrounding district.

As a postscript, on 28 March 2012 the UK Supreme Court handed down its much awaited judgment in *Employers' Liability Insurance "Trigger" Litigation: BAI (Run Off) Ltd v Durham*.[86] The issue in this case was the application of employers' liability policies to long-tail diseases, the Supreme Court ruling that the words "injury sustained" referred to exposure and not the later onset of disease, so that the insurer in the year of exposure faced liability. However, there is detailed discussion by Lord Mance of the "but for" test, and his judgment makes it clear that "but for" is to be relaxed "as a matter of legal policy"[87] where it fails to do proper justice.

C. The Trends Clause: Effects on the Vicinity

Assuming that there is coverage under the BI policy in that loss of revenue is caused by material damage to insured property, the application of the trends clause causes some difficulty when applied to a scenario in which the catastrophic event has given rise to losses wider than those affecting the assured itself. The question to be asked here is whether those external losses can be taken into account in determining the measure of indemnity. As has been shown above, the trends clause permits the upwards or downwards

84 Laid down in *Lloyd Instruments Ltd* v. *Northern Star Insurance Co Ltd*, *The Miss Jay Jay* [1987] 1 Lloyd's Rep 32, although the actual application of that principle to the facts of the case was doubted by the Supreme Court in *The Cendor Mopu* [2011] UKSC 5. Note that if the second cause is excluded rather than simply uninsured, the exclusion takes priority (*Wayne Tank and Pump Co Ltd v Employers Liability Assurance Corporation Ltd* [1974] QB 57), but there was no depopulation exclusion in *Orient-Express.* It should be said, however, that the cases on causation are for the most part in respect of concurrent rather than consecutive causes. Whether this affects the principle is a matter of uncertainty.

85 There may be other heads of cover, as indeed was the case in *Orient-Express*, but they were subject to sub-limits.

86 *Employers' Liability Insurance "Trigger" Litigation: BAI (Run Off) Ltd v Durham* [2012] UKSC 14.

87 Ibid at [55]. See also Lord Clarke at [84]. The majority accordingly held that the rule established in *Fairchild v Glenhaven Funeral Services Ltd* [2002] UKHL 22, imposing liability on every employer who had exposed an employee to asbestos on the basis that such exposure materially increased the risk of injury, was to be regarded as a special rule of causation, dispensing with a strict need to prove a causal link where medical science was unable to provide one, and deeming a causal link between exposure and injury. It was not, a held by Lord Phillips, dissenting, a rule which recognised that exposure created a cause of action.

adjustment of notional post-catastrophe revenue by reference to external factors. As regards adjustments in the indemnity period, the effect on the locality itself may be highly relevant in two respects. The first is whether the damage to the locality is to be taken into account in determining whether the assured has suffered any loss at all. The trends clause asks the question; what would the revenue have been without (but for) the damage caused by the catastrophe? The apparent answer is that, if there had not been a catastrophe at all, there would not have been depopulation and so the full amount of revenue would have been earned. Accordingly, under the trends clause, if the catastrophe is to be taken into account in assessing revenue in the indemnity period, it is possible to say that absent the catastrophe revenue would have been earned, the vicinity would not have been damaged and thus the catastrophe caused a notional loss of revenue. This was the reasoning pressed by the in *Orient-Express*. The argument ran that the trends clause was to be applied according to its wording, namely by reference to the assumption that there had not been any damage at all, including damage to the vicinity. By disregarding such damage and the resultant depopulation, the hotel would have been able to recover for revenue lost by reason of the hurricane. Hamblen J disagreed with the suggestion that it was necessary to strip the hurricanes out of the equation in the application of the trends clause to the indemnity period. The learned judge ruled that the test laid down by the trends clause was to ask what the gross revenue would have been had the damage to the hotel not occurred, and not what the gross revenue would have been had the event which caused the damage not occurred. So although the damage to the hotel was to be notionally disregarded in applying the trends clause, other damage was not. That approach reinforced Hamblen J's construction of the policy as one which responded on the basis of an assumption of an undamaged hotel in a damaged vicinity, although it reinforces the curious outcome that the greater the damage to the vicinity and thus of the risk of depopulation, the lesser the prospect of any recovery by the assured.

The second point at which the wider effect of the catastrophe becomes relevant is where the assured actually gains from it. The issue in *Orient-Express* was one of depopulation. However, it was pointed out by the assured hotel in *Orient-Express* that taking account of the damage to the vicinity could give rise to odd results where there is no depopulation but nevertheless competing businesses were themselves damaged, leaving the assured with a potential monopoly. The assured's argument in such a case would be that, but for the catastrophe affecting the assured's premises but assuming that the catastrophe had damaged rival businesses, the assured would have been deprived of additional revenue which it could have earned from its monopoly position, and the existence of that monopoly is to be taken into account under the trends clause.[88] That suggestion was denied by the majority in *Prudential*

88 This phenomenon did in fact occur in Christchurch, when those hotels which remained were extremely busy due to various emergency staff and displaced people.

v Colleton Enterprises,[89] but in doing so the majority accepted the argument rejected in *Orient-Express* that it was necessary to assess the assured's claim on the basis that a catastrophe had not occurred rather than on the basis that a catastrophe had occurred but it had affected only the assured. Hamblen J preferred the minority reasoning that it was not illogical to adjust upwards the potential monopoly revenue lost in the indemnity period on the basis that the catastrophe had given rise to the possibility that such revenue could be earned in the first place.

D. The Trends Clause and Pre-existing Losses

Further problems arise in a scenario such as that in New Zealand where there have been two separate earthquakes. Consider a hotel which had BI cover under a single policy at the time of both earthquakes. As an initial point, and subject to aggregate policy limits, it would seem that, absent language to the contrary, there are two indemnity periods. Thus, if there is a trigger of cover on 4 September 2010 so that a one-year indemnity period starts to run, followed by a second trigger of cover on 22 February 2011, then a second indemnity period would begin on the latter date, presumably subsuming the unexpired duration of the first indemnity period.

A variation may be considered. Let it be supposed that at the time of the first earthquake on 4 September 2010 there was no material damage but only vicinity damage, so that the assured was entitled to recover – if the policy contained a relevant vicinity damage trigger with a 10 per cent sub-limit –10 per cent of loss in the one-year indemnity period following the first earthquake. However, as a result of the second earthquake on 22 February 2011, there is material damage to the hotel, triggering full BI recovery for the year following that earthquake. What is immediately apparent here is that the comparator period is itself affected by the 4 September 2010 earthquake. Is it, therefore, open to insurers to argue that the assured's BI loss in the indemnity period running from 22 February 2011 is to be based on revenue in the comparator period running from 22 February 2010, even though a significant proportion of the comparator period was adversely affected by the first earthquake? This point was resolved in favour of the assured in *New World Harbourview Hotel Co Ltd v Ace Insurance Ltd*.[90] Here, the indemnity period for BI losses incurred by a hotel in Hong Kong commenced on the date on which a disease became "notifiable" and ran for 180 days. On 13 February 2003 the Hong Kong Hospital Authority adopted a voluntary notification system for the respiratory disease SARS, and on 27 March 2003 the Hong Kong authorities adopted an ordinance making notification of SARS compulsory. The epidemic came to an end on 23 June 2003. The assured sought to recover for the period 13 February 2003 (the date by which the number of visitors to Hong Kong had fallen significantly) to 23 June

89 *Prudential v Colleton Enterprises* 976 F2d 727.
90 [2012] Lloyd's Rep IR 537

2003, but the Court ruled that "notifiable" meant mandatory rather than voluntary notification, and that the period of recovery was limited to the period 27 March 2003 to 23 June 2003. However, in measuring the loss in that period, it was held that the actual loss of business in the period 13 February 2003 to 27 March 2003 was, under the trends clause, to be left out of account in determining revenue for the comparator period terminating on 27 March 2003, so that there was nothing wrong in treating the anterior effects of the insured peril itself as relevant to the trends clause. Thus, in the scenario above, gross revenue in the period up to 22 February 2011 could be adjusted upwards to take account of the profit-dampening effect of the earthquake of 4 September 2010 on revenue earned up to 22 February 2011.

IV. Reinsurance

A. Forms of Reinsurance Coverage

Insurers put in place a range of alternative and cumulative reinsurance arrangements to protect themselves against individual losses and particular types of loss. Facultative, or "one-off", reinsurance is used to protect an insurer against a large loss written on an individual basis and, under that type of contract, the insurer and reinsurers share the loss in agreed proportions (ranging from a very small percentage to, where the reinsured is simply "fronting" for the reinsurers, 100 per cent in favour of the reinsurers). Treaty reinsurance is used to protect the reinsured's portfolio of losses. The most important form of treaty in the context of the New Zealand earthquakes is excess of loss (XL) cover. Here, the reinsurance covers aggregate losses arising from a particular event, so that when total losses faced by the reinsured reach the agreed excess figure, the reinsurers' liability attaches. This form of reinsurance is non-proportional, in that there is no sharing of individual losses but rather the liability of the reinsurers attaches at the agreed aggregate excess point. There may be individual facultative reinsurances in place to protect the reinsured against losses below the agreed aggregate excess point, and other forms of proportional treaty insurance (covering policies of given types rather than losses of given types) may also be in place. Our focus here is on XL cover, which is typically used against individual catastrophic events giving rise to a large range of losses under many individual insurance policies. Any insurer whose policies provide cover against losses of the same type is likely to have XL reinsurance in place.

B. Aggregation Under XL Treaties

There are two cumulative triggers for the coverage provided by an XL treaty. The first trigger is a catastrophic occurrence which has given rise to a series of individual losses. The second trigger is that those losses arising from the catastrophic event, in the aggregate, have given rise to a total liability faced

by the reinsured which exceeds the financial point at which the reinsurance is stated to come into effect. A typical XL reinsuring clause will indemnify the reinsured in respect of its "ultimate net loss", defined as the sum paid by the reassured in settlement of each and every loss, damage, liability or expense after deduction of all salvage and subrogation recoveries. The key point is nevertheless the basis of aggregation, because that determines which losses can be added together to determine whether the trigger point for cover has been reached. Two forms of aggregation may be found. The first form of aggregation is based upon all loss arising from "any one event", for example:

> For the purpose of this reinsurance, the term "each and every loss" shall be understood to mean each and every loss and/or occurrence and/or catastrophe and/or disaster and/or calamity and/or series of losses and/or occurrences and/or catastrophes and/or disasters and/or calamities arising out of one event.

The second form of aggregation allows all losses flowing from one "originating cause" to be added together in order to determine whether the trigger for reinsurance coverage has been fixed.

It is apparent that the wider the definition of the aggregating term, the more losses it becomes possible to add together to determine whether there is reinsurance coverage. The two classes of aggregating event were discussed by Lord Mustill in the House of Lords in *Axa Reinsurance (UK) plc v Field*.[91] As to event: "in ordinary speech, an event is something which happens at a particular time, at a particular place and in a particular way". For there to be an event, the unities of time, place, intention and cause have to be present. As to originating cause:

> A cause … is something altogether less constricted. It can be a continuing state of affairs; it can be the absence of something happening. Equally, the word "originating" was … consciously chosen to open up the widest possible search for a unifying factor in the history of the losses which it is sought to aggregate."

In other words, originating cause has a much wider connotation than event. The broad distinction between the two is that an originating cause can be a state of affairs capable of giving rise to individual losses, whereas an event is an individual manifestation of a state of affairs: the former is the "what", the latter is the "why".[92] How does this all translate into XL reinsurance coverage for private insurers and for the EQC? There are various candidates for aggregation: the fact that New Zealand is susceptible to earthquakes; each of the earthquakes and aftershocks (which, it will be remembered are, in varying degrees of severity, daily happenings); and each individual loss resulting from an earthquake.

It is clear from the cases that the susceptibility of New Zealand to earthquakes cannot be an event, because an event is not a state of affairs. However, such susceptibility could potentially be an originating cause. Some support may be found for the proposition in *Cox v Bankside Members*

91 *Axa Reinsurance (UK) plc v Field* [1996] 3 All ER 517.
92 *Countrywide Assurance v Marshall* [2003] Lloyd's Rep IR 195.

Agency Ltd,[93] where it was held that the propensity of an individual to act negligently was an originating cause, so that all losses resulting from a variety of negligent acts could be added together to determine the trigger point of coverage. Again, in *Municipal Mutual Insurance Ltd v Sea Insurance Ltd,*[94] the Court of Appeal accepted that a series of numerous acts of theft from a port was to be regarded as forming an originating cause. Accordingly, it may be said that general susceptibility is not an event and would not permit all earthquake losses to be aggregated, whereas there is a respectable (albeit as yet untested) argument that XL reinsurance wording granting cover for originating causes would permit all losses from earthquakes in the policy period to be added together.

The second candidate for aggregation is each individual earthquake. There seems to be little doubt that if general susceptibility is not an originating cause, then an individual earthquake plainly does fall within that definition. More complex is whether an earthquake is an event for the purposes of an XL policy written in those terms. Even without a detailed analysis of the cases on the point, this possibility is not open to serious doubt. Some policies will indeed so specify,[95] but even if that is not the case then the alternative conclusion – that each loss flowing from an earthquake is the event – is plainly unpalatable. The excess trigger is likely to be set at a high level, and it is most unlikely that any one claim would exceed that level, so construing an XL event limit as referring to individual losses would effectively render the reinsurance worthless. In some cases the courts may be driven to that conclusion by the wording,[96] but it is plainly one to be avoided on grounds of commercial common sense if possible. The cases on "event" are borderline and often give rise to disagreements between first instance and appellate judges, but some examples may assist. The following have been held to be events: the happenings on 9/11;[97] the invasion of Kuwait and the seizure of 15 aircraft

93 *Cox v Bankside Members Agency Ltd* [1995] 2 Lloyd's Rep 43. Cf *Countrywide Assured Group plc v Marshall* (failure to train agents adequately was the originating cause of product mis-selling by the agents. See also *American Centennial Insurance Co v INSCO Ltd* [1996] LRLR 407.

94 *Municipal Mutual Insurance Ltd v Sea Insurance Ltd* [1998] Lloyd's Rep IR 421.

95 It would seem that the EQC XL reinsurance is written on the basis of aggregation for any one "earthquake event",

96 *Standard Life Assurance Ltd v Oak Dedicated Ltd* [2008] EWHC 222 (Comm).

97 *If P & C Insurance Ltd v Silversea Cruises Ltd* [2004] Lloyd's Rep IR 696.

on its airfield;[98] and a decision to use asbestos in the walls of a factory.[99] By contrast, bad workmanship,[100] incompetence[101] and a decision to orchestrate rioting in different geographical locations[102] are not events.

It will be seen that there is room for argument as to whether an earthquake is an event for XL treaty purposes. Reinsurers may point to dicta that the geographical unity is a strict one, and that losses inflicted even in different locations within the same city have been held to constitute separate events.[103] However, it is submitted that such an interpretation would make a nonsense of XL catastrophe cover, which is designed to provide for the aggregation of losses resulting from catastrophic events, and that it is almost inevitable that an earthquake would be regarded as an event.

C. Multiple Events

That is not the end of the matter, because one of the issues in New Zealand is the fact that there were two major earthquakes some five months apart, as well as a number of aftershocks which caused significant damage. Assuming that those earthquakes both fell within the same year of XL reinsurance coverage[104] the question becomes whether two earthquakes can constitute a single event. If there are two events, the reinsured will have to prove that the losses from each of them separately exceeded the XL trigger, ie, the reinsured has to bear two retentions and not just one. So this is a critical issue.

The above authorities do not deal with consecutive casualties, but it may be thought that it is difficult to derive from them much support for the argument that two earthquakes are one event. That comes close to arguing that mere susceptibility is an event, although the argument gains some support from scientific approach which classifies a series of earthquakes, in geological terms, as a single seismic event in so far as each of the earth movements is part of a single overall "event" that may of itself last several years. But if that extreme approach is rejected, a difficulty still arises where the earthquakes are linked, and that the second can be said to be the direct consequence of the first. Indeed, as noted earlier, the geological classification of the 22 February 2011 earthquake was that it was an aftershock from the 4 September 2010

98 *Kuwait Airways Corporation v Kuwait Insurance Co SAK* [1996] 1 Lloyd's Rep 664. But contrast *Scott v Copenhagen Reinsurance Co (UK) Ltd* [2003] Lloyd's Rep IR 696, where a 16th aircraft, belonging to BA and not an intended target of the invasion, was held to constitute to fall outside the invasion event.

99 *IRB Brasil Resseguros SA v CX Reinsurance Company Ltd* [2010] EWHC 974 (Comm).

100 *Seele Austria GmbH & Co KG v Tokio Marine Europe Insurance Ltd* [2008] EWCA Civ 441.

101 *Caudle v Sharp* [1995] LRLR 433; *American Centennial Insurance Co* v. *INSCO Ltd* [1996] LRLR 407.

102 *Mann v Lexington Insurance Co* [2001] Lloyd's Rep IR 179.

103 Ibid. See also Aioi Nissay Dowa Insurance Co Ltd v Heraldglen Ltd [2013] EWHC 154 (Comm) (the attacks on the Twin Towers on 9/11 were two events and not one, although the court endorsed the arbitrators' view that it was appropriate to look at the unities of time and geography by reference not just to the damage but also to the origin, check in and destinations of the two flights).

104 Such contracts cover the occurrence of the event.

earthquake. However, it is suggested that the argument that aftershocks can be treated as part of the same event as the primary earthquake is ruled out by the known use of "hours" clauses.[105] Consider the following "hours" clause:

> Each loss by earthquake shall constitute a single [event] hereunder, provided, if more than one earthquake shock shall occur within any period of seventy-two (72) hours during the term of this policy, such earthquake shall be deemed to be a single earthquake within the meaning hereof.

So here is the wording which ensures that earthquakes can be treated as a single event if they occur within 72 hours of each other. Thus, for example, the seven shocks of greater than 5 magnitude which occurred in the few minutes from 4.35am on 4 September 2010 are to be treated as a single event. However the New Zealand earthquake events on 4 September and 22 February (which of themselves constituted several shocks) did not occur within 72 hours of each other, so that if there was an hours clause it becomes difficult for the reinsured to aggregate earthquakes and aftershocks into a single event even though they were more than 72 hours apart. The same follows even if the XL treaties do not contain hours clauses. Such clauses appear in a variety of formats and specify durations ranging from 72 hours to 168 hours, but they are commonplace. In the light of evidence to that effect, a judge or arbitral panel would almost certainly feel comfortable with the argument that failure to use an hours clause demonstrated an intention that temporal aggregation was not possible, and that each earthquake is to be treated as a single event.[106]

D. Proof of Loss Under XL Treaties

Most insurance claims are settled rather than resolved by litigation. A reinsurer is, however, only liable to indemnify the reinsured for claims in respect of which the reinsured's loss has been established and quantified by a judgment, arbitration award or settlement which also falls within the terms of the reinsurance contract. In the case of a settlement with the policyholder, the reinsured is required to establish on the balance of probabilities that, if he had been sued to judgment by the assured, the sum awardable would not have been any greater than the settlement figure., If that can be done, the settlement can be treated as part of the reinsured's loss. If the reinsurance is facultative, it is a common but not universal practice for the agreement to contain a "follow the settlements" clause under which the reinsurers agree to be bound by any settlement entered into by the reinsured unless the reinsurers can prove that it was not made in a bona fide and business-like fashion. Pure

105 Most policies do have general hours clauses not related to earthquakes but just to events, and that leans against the classification of an earthquake as one event.

106 The professional indemnity equivalent of an hours clause is the series clause, which allows any series of related acts or omissions to be one act or omission for the purposes of a claim. See: *Lloyds TSB General Insurance Holdings v Lloyds Bank Genenal Insurance Co Ltd* [2003] Lloyd's Rep IR 623; *Beazley Underwriting Ltd v Travelers Companies Inc* [2011] EWHC 1520 (Comm).

ex gratia payments will, therefore, be excluded, but as long as the settlement is arguably founded on the reinsured's legal liability it will be binding even if it is later shown that the reinsured did not face any liability.[107]

That process is all but impossible to replicate in the case of an XL treaty. The reinsured has to show that aggregate losses have reached the limit prescribed by the treaty for the attachment of cover, and if it was the case that the reinsured had to demonstrate legal liability for each of the many thousands of claims which go to make up aggregate liability, there would be little or no prospect of recovery. Contract terms tend not to help. XL treaties do not use the generous facultative "follow the settlements" wording but instead tend to adhere to the "loss settlements" clause, of which the following is commonplace:

> All loss settlements made by the Reinsured, including compromise settlements, shall be unconditionally binding upon Reinsurers provided such settlements are within the conditions of the original policies and/or contracts and within the terms of this reinsurance

Although the title of the clause conveys the impression that some sort of concession is being made to the reinsured, this is not the case. Careful examination of the wording shows that the reinsurers do not face liability unless, as a matter of law, the losses fall within the terms of both the insurance and the reinsurance, a good summary of the common law position.[108] What, then is the reinsured to do if the reinsurers assert that some of the reinsured's settlements were not based on legal liability? The nightmare scenario that a reinsured can safely settle an individual claim only after being sued to judgment on it, has to some extent been removed by the English courts in a pair of cases, *Equitas Ltd v R&Q Reinsurance Company (UK) Ltd*[109] and *IRB Brasil Resseguros SA v CX Reinsurance Company Ltd*.[110] In each, the court held that as long as the reinsured had established and quantified its liability on the balance of probabilities, the court was not concerned with the fine details of each of the underlying claims. However, these cases involved global settlements involving many thousands of claims, and the issues were in essence factual. In *Equitas* the question was quantum, liability having been established. In *IRB* there were class actions, and it was clear that many of the claimants in those actions had perfectly good claims, so the global settlement overall was regarded as reflecting at least the potential liabilities of the reinsured, even though it was inevitable that many of the claims included within the settlement would have been invalid or overstated

Those cases do not, however, provide any assistance where insurers settle a group of claims based on a mistaken view of the law, misinterpretation of underlying policy wordings and incorrect allocations of loss to policy years.

107 *Insurance Co of Africa v Scor (UK) Reinsurance* [1985] 1 Lloyd's Rep 312; *Assicurazioni Generali SpA v CGU General Insurance plc* [2004] Lloyd's Rep IR 457.

108 See *Axa Reinsurance (UK) plc v Field* [1996] 3 All ER 517.

109 *Equitas Ltd v R&Q Reinsurance Company (UK) Ltd* [2009] EWHC 2787 (Comm).

110 *IRB Brasil Resseguros SA v CX Reinsurance Company Ltd* [2010] EWHC 974 (Comm),

If there is a demonstrable error of law which has affected many claims, then it would seem that those claims cannot be treated as forming part of the XL cover open to the reinsured. There was reference earlier in this paper to the suggestion that insurers who unreasonably delayed in making payment might find themselves facing liability in damages to the assured. But can it be said to be unreasonable for insurers to satisfy themselves that the policy wording actually covers the loss in question, failing which they face denial of liability by their reinsurers? It may be that test cases on policy wordings are required before payment can safely be made by insurers. Indeed, one practical implication of the uncertainty as to coverage has led to a high degree of involvement of reinsurers with individual claims leading to delay and a lack of decision-making autonomy by insurers.

E. The Destination of Reinsurance Recoveries

It is trite law that contracts of insurance and reinsurance are entirely distinct, so that at common law a policyholder has no claim against its insurer's reinsurers in the event of the former's default (typically as the result of insolvency). That position prevails in England,[111] although has been reversed by legislation in Australia.[112] There is legislation in England – the Third Parties (Rights against Insurers) Act 1930[113] – under which the victim of an insolvent assured has a direct claim against the assured's liability insurers in the event of the assured's insolvency, but reinsurance is specifically excluded.[114] The New Zealand equivalent of the UK's 1930 Act is s 9 of the Law Reform Act 1936, which adopts the rather different technique of impressing the policy moneys with a charge in favour of policyholders. In the case of a contract by which the policyholder "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 money that is or may become payable in respect of that liability." This section, which is enacted in more or less identical terms in New South Wales,[115] has proved to be problematic in the extreme, and even since its description by Professor Sutton in 1999 as "opaque and ambiguous"[116] it has caused consternation in the professional

111 Some US contracts contain "cut-through" clauses whereby policyholders can sue reinsurers directly in the event of the insurer's insolvency, but they are not used in England as it would seem that they constitute charges on the insurer's assets within the Companies Act 2005 and thus are void against the liquidator for want of registration.

112 Corporations Act 2001 (Cth), s 562A.

113 Due to be replaced from a date to be announced by the Third Parties (Rights against Insurers) Act 2010, without substantive change on the point under discussion.

114 S 1(5) of the 1930 Act, s 15 of the 2010 Act.

115 Law Reform (Miscellaneous Provisions) Act 1946 (NSW), s 562A.

116 Initial? Sutton, *Insurance Law in Australia* (3rd ed, Publisher and location of publication?, 1999) at [2.116].

indemnity market by a ruling in Auckland in September 2011[117] to the effect that the charge attaches at the date of the negligent act, thereby preventing the assureds from obtaining any upfront payment for defence costs.[118] That aside, there is now New Zealand authority for the proposition that the 1936 Act applies to reinsurance.

The point arose following the collapse of Western Pacific Insurance Ltd, which went into voluntary liquidation in 2011 facing unsettled claims of some NZD 60 million, NZD 40 million of which related to the two Christchurch earthquakes. Its excess of loss reinsurance treaty for the 2010 year provided cover of NZD 20 million with an event deductible of NZD 1 million, and the 2011 treaty was for NZD 15 million with the same deductible. Reinsurers treated each earthquake as an event, giving a pay-out of NZD 33 million. The question in *Ruscoe and Thorn v Canterbury Policy Holders*[119] was what should happen to the proceeds. The High Court's view, on an application for directions by the liquidators, was that s 9 applied to reinsurance and that the treaty proceeds were subject to a statutory charge in favour of the policyholders. The court reasoned that the insurers were under a liability to pay "compensation" to policyholders so that, whether or not the section was designed to apply to reinsurance, it did so as a matter of law. This decision will doubtless be welcomed by earthquake victims, but it is hardly supportable.[120] The suggestion that insurance moneys are "compensation" is a novel one, although the court might have been on stronger ground if it had decided that insurance moneys are "damages". That point aside, the section may work properly in the case of a facultative contract, but applied to excess of loss reinsurance the results are arbitrary. There are no reinsurance proceeds for claims within the deductible, and the reinsurers' liability attaches as soon as liability is established and quantified. It may thus be necessary[121] to discount the earliest claims, so that the statutory charge would apply only to those later claims which took the loss above the deductible,[122] not an outcome which would appeal to anybody.

117 *Steigrad v BSFL 2007 Ltd* [2011] NZHC 1037, a sequel to the collapse of Bridgecorp.

118 To counter the decision (which is under appeal) policies now provide for separate limits of indemnity for substantive liability and defence costs, thereby ring-fencing the latter from the statutory charge.

119 *Ruscoe and Thorn v Canterbury Policy Holders* (2012) 17 ANZ Insurance Cases 61-921.

120 The court's discussion of the nature of reinsurance, albeit limited, ignored the analysis in *Wasa International Insurance Co Ltd v Lexington Insurance Co* [2009] UKHL 40 where it was made clear that facultative reinsurance is *not* liability cover, although it does not follow that excess of loss reinsurance is to be classified in the same way.

121 In accordance with *Teal Assurance Co Ltd v W R Berkley Insurance (Europe) Ltd* [2011] EWCA Civ 1570.

122 The court recognised that there was a practical difficulty in that claims were pooled, but did not regard that as insurmountable. The allocation issue was not considered.

F. EQC's Reinsurance

The reinsurance put in place by the EQC is XL in form, and its nature was disclosed in the evidence in *Tower Insurance Ltd v Earthquake Commission*.[123] As noted above, the reinsurance requires EQC to bear the first NZD 1.5 billion of claims, and cover of NZD 2.5 billion attaches for each "loss occurrence". That term of aggregation is defined as meaning all individual losses arising out of and directly occasioned by one "catastrophe". A catastrophe in the form of an earthquake is defined as including all earthquakes occurring within 720 consecutive hours (30 days) and a 250 kilometre radius of the original earthquake. It is apparent from this definition that there are two significant catastrophes, so that the EQC has two claims of up to NZD 2.5 billion in excess of NZD 1.5 billion. This assumes of course that an aftershock is an "earthquake" for this purpose: if not (and an argument to that effect would be technical in the extreme) then there is cover only for one loss occurrence.

V. Conclusion

There have been demands from consumer and business organisations, and indeed from the New Zealand government, for earthquake losses to be settled with the minimum of delay. However, within the existing structure, that is more complex that it might at first sight seem. There are the initial practical problems of mass claims-handling. Leaving that aside, it is clear that New Zealand policies have left plenty of room for dispute as to the scope of cover, in particular with the issues that might arise from consecutive earthquakes being either unappreciated or disregarded. Insurers will, of course, wish to do "the right thing" and make speedy payment – sometimes ex gratia – so that they can relieve at least the financial pressures on policyholders without adding to their woes. However, if a large number of claims raise the same coverage issues, insurers are at risk of losing their reinsurance coverage unless liabilities are tested and resolved or unless reinsurers can be persuaded to accept liability even though underlying coverage is disputed.

What is clear is that the New Zealand insurance market cannot itself carry the financial risk of further earthquake events. Reinsurance is essential, although of course the international reinsurance market itself has faced massive recent challenges from flood, tsunami and other natural catastrophes. If the New Zealand system was to be left as it stands, and attention was focused on reinsurance, one possible way forward might be for insurers to move away from reinsurance policies in traditional form and to seek cover from the Alternative Risk Transfer (ART) market. The obvious mechanism is that of the Catastrophe Bond, a securitisation device which shifts the reinsurance risk away from traditional reinsurers to capital markets, through the issue of bonds to investors. Most Catastrophe Bonds respond to claims for indemnity, but an increasing number respond to the occurrence

123 *Tower Insurance Ltd v Earthquake Commission* [2011] NZHC 943.

of a catastrophe. Such "parametric" instruments provide for payment to the insurers where, for example, an earthquake occurs of given force in a given region, or where there is a constant run of adverse weather conditions for a given period. This type of payment is not contingent upon proof of loss or liability and is triggered purely by the objective existence of the catastrophe so defined. There is some dispute as to the nature of these arrangements, and indeed whether are reinsurance at all[124] but they plainly have the macro advantage of expanding capacity and the micro advantage of the removal of claims-handling regulation by reinsurers.

However, it is apparent to the present author that the problems are more fundamental. The EQC scheme has not delivered. It is underfunded in that the premiums payable by policyholders for this form of cover have no actuarial basis, it provides compensation based on unrealistically low measures of land value and there is too much room for dispute as to the interaction between EQC cover and that proffered by the private insurance market. The scheme is also iniquitous, in that it benefits only those who have taken out fire insurance. While an insurance obligation as a condition of recovery is not an unreasonable one in principle, it looks less so when the sum paid for earthquake cover does not come close to an actuarially assessed premium. Further, the fault may not be that of the assured but that of his broker and a failure by a broker to obtain a fire policy removes EQC coverage:[125] all is well if the broker has valid professional indemnity insurance, but if the broker has acted dishonestly he will not.[126] For its part the private insurance market has proved to be deficient, in that the policy wordings are at best loose or ambiguous and in that many of the key issues that have arisen, although foreseeable, have been left over for ex post facto resolution. Unless there is a policy decision that people must bear their own losses, in which case the state will be required to pick up other bills, eg, those of rehousing, it is necessary to consider what the most efficient loss-spreading mechanism might be. EQC is effectively a form of social insurance which offers minimum cover for an unrepresentative premium not paid by all and is propped up by state funding.

Other models are available.[127] In the UK, by way of example, the withdrawal by the insurance market of terrorism cover from commercial buildings in the early 1990's, threatening the continuing London presence of leading financial concerns, led to the passing of the Reinsurance (Acts of

124 They are regulated under EU law as if they were reinsurance, so that insurers are permitted to protect themselves with Catastrophe Bonds administered by Special Purpose Vehicles as long as the national regulator is satisfied that there is appropriate security for the reinsured.

125 *Marchand v Jackson (No 2)* [2012] NZHC 2893, where the broker was held to be liable to the assured for failing to place property insurance, thereby depriving the assured of EQC cover as well.

126 See the allegations in *Marchand v Jackson* [2012] NZHC 944, a prequel to the substantive hearing. There are likely to be further proceedings on the substance of these allegations.

127 For European Union analysis of insurance and Natural Catastrophes, see its report, published in January 2012: <europa.eu>

Terrorism) Act 1993.[128] Under this measure the private market offers – if it wishes to do so – insurance coverage for terrorism risks, but is reinsured at commercial rates by a state-sponsored reinsurer, Pool Re which must offer reinsurance coverage to willing insurers. The scheme has been a resounding success in terms of ensuring coverage, although it should be said that there has not been a major terrorist incident in London aimed at commercial buildings for 20 years so the scheme has not been put to the ultimate test. But the lure of mandatory reinsurance might tempt local insurers into the earthquake insurance market. It would then be for government to decide whether an insurer which offered fire cover was required to offer earthquake cover and if so, at affordable rates.

128 In 2006 the author surveyed a number of jurisdictions to see how the problem of withdrawal of terrorism cover has been dealt with. There is a fascinating array of national solutions involving compulsion of different types, any of which could be a model for earthquake insurance. The report is on the website of the International Association of Insurance Law. The Australian experience of compulsory insurance for flood damage is also worthy of study.