

Address by Peter Faire to Annual CILA Conference 2016

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New Zealand Earthquakes: Christchurch 2010 – 11 and BI Issues

Introduction

Thank you for inviting me to speak at the 2016 CILA Conference. I have been a proud member of this Institute since 1979, when I joined the Australasian Division. I was President of that Division in 1984/85.

I last addressed a CILA Conference in Harrogate in 1985. I spoke then on the need for the Institute to prepare itself for the 21st century and change its Charter to allow the honest and responsible marketing and promotion of our professional services. Perhaps it was radical at the time, but at that AGM the Institute appointed a special committee to prepare submissions to change the Charter. We did, and the rest is history. I am told the Institute is considering further important changes in 2016?

In the first part of my address today I have been asked to give you a snapshot of what is apparently the largest insurance earthquake disaster in global history and the largest natural disaster in New Zealand history. I mean a snapshot, because there isn't time to do more. Much has already been written on a disaster that destroyed most of New Zealand's 2nd largest city with 400,000 inhabitants. There are more books, research projects, public enquiries and even Police investigations, in the pipeline.

I have consulted widely across the insurance industry and with the many professions who have been involved in the aftermath in an attempt to minimise my biases and hopefully give you a more balanced picture.

Later in this address, I discuss a couple of the more controversial BI concepts that caused significant problems in Christchurch. I will be most interested in your reactions and feedback.

Who is Peter Faire?

Perhaps there is no one here today old enough to remember my active days in this Institute or when I was a regular visitor to the UK as the Asia Pacific CEO and a global director of GAB Robins?

When I resigned from GAB Robins in the mid 1990's I returned to New Zealand from Sydney and re-activated Fawcett Faire, this time to act for the insured, particularly in BI claims, which are my technical specialty. I was too young to retire in 1996, but I didn't want to compete with my old firm either.

I began adjusting BI claims in 1975, initially as a partner in a Chartered Accounting firm, and from 1979 as co-founder of Fawcett Faire & Company, Chartered Loss Adjusters.

By the mid 1980's, we had merged with several other loss adjusting businesses in Australia and New Zealand to form the dominant Australasian MBS Loss Adjusters Group. In 1987, MBS was sold to SGS in Switzerland to become part of the global GAB Robins Group (now Cunningham Lindsey).

New Zealand: Historical and Legal Context

New Zealand is a UK-style jurisdiction that also adopts (and adapts – badly sometimes!!) most UK insurance policies. US influence is limited. Pre Christchurch there were relatively few New Zealand property insurance legal precedents and no BI. Historically, NZ has relied on UK legal precedent.

However, the numerous contentious technical issues that have arisen in MD and BI claims in Christchurch have resulted in unprecedented litigation over the past 6 years. Litigation is likely to continue for several more years. There are now many NZ MD legal precedents, particularly relating to the unexpectedly generous cover provided by the typical 'new for old' Replacement cover - unexpected by many local insurers.

Insurers have been generally unsuccessful in this litigation. The Appellate Courts in particular, have tended to focus on 'intention' and not the 'fine print'.

Time will tell how persuasive these judgements remain. There is only one BI precedent, unhelpful and relating only to Additional Increase in Cost of Working.

New Zealand's Earthquake Resilience

Given the severity of the multiple quakes and the scale of the devastation in Christchurch, it is extraordinary that the death toll at 185 was so low. There have been many less severe earthquakes around the world that have resulted in the loss of hundreds of thousands of lives.

New Zealand expects earthquakes and designs its structures to save people, but kill buildings. Being a small population and small economy we can't afford to build to the standards of say Tokyo. We are the same size as Japan (and the UK), but with about 5% of the population.

115 or the 185 fatalities were in the CTV Building which had a devastating 'pancake' collapse in the February 2011 quake. Faulty design and construction resulting from alleged fraud have subsequently been discovered and are the subjects of ongoing Police investigation.

What happened in Christchurch?

When the first earthquake hit Christchurch on 4 September 2010, I had semi-retired, or so I thought. Within days I had re-activated my firm, taken on staff (mainly 'retired' former colleagues) and set up shop in Christchurch.

We quickly attracted the large commercial MD/BI claims and to date have assisted in the settlement of only about 100 claims out of several hundred thousand, but with a total value in excess of NZD2.5 billion (Stg1.5b). None has ended in litigation and it seems my legacy has become about a dozen high value residential claims. There are thousands of residential claims outstanding, but I can't help everyone.

By the way, who has been to New Zealand? Christchurch? Before 2010? After 2010? Who has worked on claims in Christchurch?

Let me give you some summarised, high level statistics about the earthquakes:

- **4 September 2010:** A Richter 7.1 earthquake at 4.00am with a maximum Peak Ground Acceleration (PGA) of about 0.5g. No loss of life or serious injury, but significant property damage.
- **22 February 2011:** A 6.3 at 12.51pm on a working day. It was shallow, in the CBD and with a PGA up to 2.2g. Seismologists rated that quake a 1 in 1000 year event.
- 185 people died and there were thousands of injuries. There was serious damage and destruction throughout the City, with widespread liquefaction. Roads, bridges, the Port, the Cathedral, most commercial buildings and underground infrastructure were extensively damaged or destroyed. The international airport was spared.
- The Government declared a national state of emergency and gave themselves powers not seen since the 2nd World War.
- A separate Government agency, the Canterbury Earthquake Recovery Authority (CERA), was established and a senior Government minister appointed to administer these powers.
- The CBD was evacuated and a fenced cordon was established, guarded by armed soldiers and Police – unprecedented in NZ. Entry was restricted to recovery personnel only. It remained that way for two years.
- Most of the CBD has now been demolished and several residential areas have been permanently condemned and all structures removed. Many thousands of houses and almost every structure in Christchurch suffered some sort of damage.
- Just when we all thought it was over, another violent and shallow 5.8 quake hit on 13 June 2011, adding extensive further damage to already seriously weakened structures.
- There have been about 12,000 aftershocks since September 2010, several of them significant, and they keep coming. There was another 5.7 on 14 February this year.

- The total economic cost is now thought to be approaching NZD70 billion (about Stg37 billion) of which about NZD40 billion is estimated to have been insured, at least partially.
- The Government-owned Earthquake Commission (EQC) covers the first NZD100,000 of residential damage per event, and was heavily involved. It also cover some residential land damage.
- Having effectively two independent insurers separately dealing with the same claim was not successful.
- The EQC had inadequate reinsurance and has ended up being underwritten by the taxpayer for many billions.
- Resources were exhausted quickly – insurer claim personnel, adjusters, claim preparers, engineers, construction professionals, lawyers, emergency services, contractors and suppliers were all overwhelmed. Consequently there was often a lack of response and claims were delayed.

The Claims

The several hundred thousand claims arising from the multiple events were overwhelming for insurers and adjusters. Let me describe some of the issues and problems:

- Most commercial and residential Policies provided 'new for old' and fully legally compliant repair or rebuild.
- Residential Policies generally had no sum insured and were limited only by the specified area of the dwelling. With hindsight this marketing giveaway has been something of an unexpected financial disaster for insurers.
- Many Policies had not been issued. Contract certainty was a serious problem.
- No Policies contained coinsurance or average provisos. There are statutory reasons for this in NZ.

- Insurer communication was often inadequate. Policy response and the rights of insureds were often ignored or misrepresented, perhaps through a lack of knowledge and inadequate training of adjusters and insurer claims personnel?
- A reluctance to make payments on account of commercial claims and the early reference by insurers to legal advisers, often delayed claims and affected business cash flow, viability and continuity.
- A reluctance to settle residential claims has seriously affected the physical, mental and financial well-being of homeowners. Residential claim settlements have been slow by international standards, so slow they are becoming time-barred.
- Constant changes of adjusters and insurer claims personnel meant a lack of continuity. I have had claims with up to eight insurer/adjuster handovers during the course of the settlement process.
- Brokers were more often salespeople for insurers instead of advocates for insureds. Inadequate Policies that did not respond as intended have led to substantial PI claims against brokers.
- Professional consultants and contractors who worked only for insurers were often publicly identified as 'hired guns', whose job appeared to be to understate the damage, promote 'quick fix' and shoddy repair solutions, and generally keep the quantum of the loss as low as possible. This has fuelled acrimonious disputes and the Courts have levelled harsh criticism at many of these so-called 'experts'.
- Several insurers set up 'Project Management Offices', complete with their own builders and construction consultants. Insureds, particularly residential, have been pressured by insurers and adjusters into using these services as a source of reinstatement estimates and the actual repair, notwithstanding insureds' rights to independent advice and to undertake the reinstatement themselves. These arrangements have produced substandard repairs or undervalued settlements.

- Early on there was a loss of confidence in insurance companies and loss adjusters, who were seen as obstructive and unsupportive. Not surprisingly, the media leapt on this bandwagon and accused insurers of trying to cheat insureds out of their rightful claims.
- Six years on there are still thousands of unsettled claims, mainly residential. This has delayed the recovery of Christchurch and led to bankruptcies, suicides, widespread depression and family breakups.
- It's been an unequal battle for SME's and homeowners in particular. Their lack the knowledge of insurance and building construction, and without the time, confidence, emotional and financial resources to do justice to their claims without specialist representation, they have been at a significant disadvantage. They needed and still need, advice and assistance, but for most it has been unavailable or unaffordable.

Insurers in Trouble

Disasters of this magnitude affect the financial viability of insurers, even in a small market like NZ, with predominantly overseas owned insurers:

- Western Pacific – a small local insurer – bankrupt. Few claims paid
- AMI: The major domestic insurer in Christchurch. Inadequate reinsurance. The Government decided it was 'too big to fail' and took it over. It is now a run off company, costing the taxpayer billions and always in Court as it tries to keep settlements low.
- Ansvar (owned by the UK-based Ecclesiastical). It went into administration of some sort with arrangements with creditors/policyholders, then cancellation of all existing policies and a complete withdrawal from NZ.
- IAG (Australia): The biggest insurer in NZ announced it was over cap on reinsurance for February 2011 claims.
- Vero (Australia): Believed to be over cap on reinsurance for February claims.
- Tower: Believed to be over cap on reinsurance for February claims.

Independent Loss Adjusters

As one of the founders and former CEO of the largest Chartered Loss Adjusting firm in Australasia, and someone who has experienced insurance disasters all over the world, I was generally disappointed in the performance of independent adjusters. However, to be fair, the scale of the disaster and the number of claims were completely overwhelming, probably even for the major European and US markets.

Many temporary adjusters were recruited on short term contracts from all over the world to cope with the unprecedented volume of claims (for under 6 months for tax reasons). The well trained UK adjusters generally coped well and performed well. However, others, including Australians, South Africans, Canadians and Americans, struggled with a lack of local knowledge and unfamiliarity with NZ law and practice. There are definitely lessons to be learned. [\[Anecdote about Canadian 'BI' adjusters\]](#)

Issues with adjusters, even local, included:

- A failure to demonstrate professional impartiality – adjusters were often seen as merely the ‘couriers’ of insurers’ opinions and edicts, sometimes inaccurate and misleading.
- Arrogance, bullying and a lack of compassion.
- Incompetence among the many short term emergency recruits to adjusting firms. One firm hired about 50 CA’s with no background in insurance or insurance claims to assist with BI claims. While I acknowledge the overwhelming volume of claims, this was not effective.
- Remote ‘desktop adjusting’ of SME claims by people who had never been to Christchurch, before or after the earthquakes, was unsatisfactory and frustrating for insureds. These ‘adjusters’ refused to visit the site, talk with the insured or understand the business.
- Multiple changes of adjuster meant no continuity. It was not uncommon for claims to have to start again several times.

- Unnecessary and unreasonable requests for information.
- Failure to respond to telephone calls, emails or correspondence within a reasonable time, or at all.
- Delays in processing progress payments essential to the survival and recovery of many of the affected businesses and individuals. Some insurers refused to make progress payments at all, which did not go down well with the Courts.
- With BI claims, a lack of understanding of the business concerned, and business generally.

Post Earthquakes 6 Years On

Most insurers these days are listed public companies with an eye to the short term bottom line and the share price. Ironically, many have reported record profits since the earthquakes following substantial rises in premiums and restrictions in cover across the country, blamed on the earthquakes, irrespective of proximity to them.

There is evidence currently that insurers are delaying progress and trying to force homeowners to accept low cash settlements, with only about 60% of residential claims settled to date.

Many insurers publicly admit they are out of reinsurance cash, at least for the February 2001 event. There is little most homeowners can do. There is no robust external regulation in NZ relating to insurance claims and expensive litigation against an insurer is not an option for most insureds.

This is not the forum to have a philosophical discussion on the contemporary structure of the insurance industry. However, the lack of alignment of interests of policyholders and the shareholders of insurers in a natural disaster was in sharp focus.

Challenges from Christchurch

Business insurance is critical to the survival, recovery and continuity of any commercial enterprise and personal insurance is essential in any first world economy.

Although New Zealand is generally well served by the availability of suitable insurances, in Christchurch there have been many challenges and hard lessons learned. MD and BI Policies have not always responded to the earthquake damage and disruption, including BI in respect of WAD.

MD Challenges included:

- (a) Most Policies were full 'new for old' replacement contracts, but with replacement values usually set for fire, not a catastrophic natural disaster. There was inadequate consideration of normal disaster factors, including serious under-valuation of in ground services, serious under - estimation of demolition and removal of debris, supply shortages, lack of competitive bids, profiteering by suppliers. Consequently, serious under-insurance was common.
- (b) The 'new for old' Policy Reinstatement Memorandum: A widespread lack of understanding about how it worked, with even insurers seemingly taken by surprise.
- (c) Cost escalation: 30% - 50% was not uncommon in the first 2 – 3 years.
- (d) Building Codes: Authorities 'moved the goal posts' post earthquakes.
- (e) Confusion over the Auto Reinstatement of cover after each event. The Courts soon sorted this out.
- (f) Multiple events and the so-called 'stacking' of claims. The Supreme Court ruled that the Policies were per event or per happening and that the damage from each event and its value should be attributed to that event. It was strange that this seemed to be a surprise.
- (g) Inability to get Contract Works insurance to allow reinstatement to proceed. There has often been no insurance available once reinstatement has been completed.
- (h) The traditional percentage of 'loss' natural disaster deductibles converted post earthquakes into financially unmanageable percentages of combined MD and BI sums insured or site values.

- (i) Confusing and contradictory language in Policies.
- (j) Residential 'new for old' uncapped area based Policies proved very expensive for insurers.
- (k) Limited legal precedents.

BI Challenges included:

Most matters discussed in the UK BI working party booklet, *Challenges Highlighted by Claims Experience* [UK 2012] have emerged in Christchurch earthquake BI claims, including:

- (a) Underinsurance, leading quickly to a lack of funds prejudicing survival and recovery.
- (b) Indemnity periods universally too short.
- (c) Multiple events, the accurate identification of incremental losses and the relationship to multiple BI claims.
- (d) WAD and OEH issues.
- (e) The Red Zone Cordon around the CBD, connected to WAD and OEH.
- (f) Application of the Dependency Extensions.
- (g) 'Residual Value' increased cost allocation within and outside the Indemnity Period.
- (h) Savings in depreciation [UK *Synergy case*].
- (i) Misunderstanding of the workings of loss of rents claims.

There are possible solutions for many of these issues, but today is not the time to consider them. That will take months, assuming the industry is prepared to enter into constructive dialogue?

TWO MAJOR BI ISSUES

Most challenges highlighted by claims experience examined in the 2012 *Challenges Highlighted by Claims Experience* paper by the Research Study Group 265 manifested themselves in some form in Christchurch earthquake BI claims.

At a gathering like this there isn't time to examine them all. However, there were two controversial issues, which I tried hard to get before the NZ Courts in disputed earthquake claims, and almost got there. At the 11th hour in all cases the insurers pulled out and settled on my terms. It seems they decided there was too much uncertainty around the response of the Courts and the possibility of unwanted precedents shaping the future.

Wide Area Damage (WAD) and the 2010 Orient Express Hotels (OEH) Decision

WAD and its impact on BI claims have been hotly debated by insureds, insurers, lawyers and claim professionals for many years. There seems to be little agreement on the extent to which the standard, UK-style BI Policy can or should respond to losses resulting from perils that simultaneously cause damage to insured property and to the wide area in which the insured property is located.

In my experience, most WAD claims are settled by negotiation between insureds and insurers, with concessions and compromises to reach a position that broadly reflects the pre loss intentions and expectations of the parties.

I am not aware of a relevant BI legal precedent before the judgment in *Orient Express Hotels v Generali* in May 2010. This case was an appeal against an Arbitration Award for an alleged error of law. For this and other reasons, it has its critics.

To my knowledge, the principles have not been tested in a BI claim put directly to a Court? However, from 2010 when the first Christchurch earthquake struck, insurers adopted the OEH decision with determination to justify substantial reductions or even elimination of many BI claims.

Over many years, BI practitioners have developed different views. Some say that the *'but for the damage'* view adopted by the Court in OEH has the potential to produce artificial 'windfall' gains and losses for insureds and insurers in certain circumstances.

Others, including me, say that if you take the damage away to create a *'but for the damage'* standard for the Insured, you can only do that in the real world by taking away the event that caused the damage to the insured property and the wide area.

In other words, you restore the pre event status quo or 'business as usual' (BAU) status. I maintain that the artificial outcome of OEH with its windfall gains and losses was never contemplated or intended by insureds or insurers when the BI Policy was first developed, or when it was sold in Christchurch before the earthquakes. Insurers will usually acknowledge that they intend to pay for BI losses suffered based on the actual damage to insured property. After all, this is the risk they underwrote.

I believe that standard BI Policies used in jurisdictions that follow the UK were constructed to provide cover for losses from a single incident (usually a fire) causing damage to a single insured. They did not contemplate WAD and have difficulty responding to it without 'bending the rules', so to speak.

The standard BI Policy as we know it is designed to insure loss of Gross Profit arising from a shortfall in turnover and net increased costs incurred, both as a consequence of damage to insured property. The loss is measured against a standard turnover (Gross Profit) that would have been achieved *'but for the damage'* to the insured property, not 'but for the event', or the peril causing the damage.

Most contemporary BI Policies, at least in New Zealand, are extended for extra premium to cover BI loss resulting from damage to insured property caused by natural disasters, including earthquake. However, if the same *'but for the damage'* test is applied, insurers argue they don't have to respond as they would for say a fire.

In fairness to insurers, it is understandable that they would not want a BI Policy to respond fully to the broader losses caused by a peril instead of the loss confined to the damage to insured property. They could end up 'insuring the world' for even minor damage to insured property.

The so-called Dependency Extensions included in most Policies today provide limited additional protection for WAD losses. However, the consequences of a situation like the multiple Christchurch earthquakes can generate unintended and unrealistic windfall gains and losses for insureds and insurers.

I have acted only for insureds in Christchurch and in many claims found myself in conflict with insurers and the loss adjusters. Pre Christchurch, it had been my experience as an adjuster and then as a claims preparer that the event that gave rise to the damage in a WAD situation was not applied by insurers as a 'special circumstance' adjustment to arrive at the primary standard against which the insured BI loss is measured.

For the first time in my experience in NZ, perhaps because the quantum of losses was so great, insurers began applying the OEH principles to Christchurch BI claims. In many cases, they eliminated most or all of an insured's BI claim, with the insurer conceding only token claims for Prevention of Access or Public Authorities (not both), without the benefit of a primary Gross Profit claim. It was argued that an insured could not have a Gross Profit claim and an Extension claim.

The flip side of this coin (e.g. some hotels) allowed some insureds to argue for artificial and substantial windfall gains on a 'last man standing' basis that could never have occurred in practice, before or after the earthquakes.

In late 2016, most of my Christchurch BI claims have been settled (without litigation I'm pleased to say), and I can confirm that none was settled based on the OEH principles. All settlements have been based on a pragmatic BAU assessment, applied in a common sense way that endeavoured to reflect the likely impact of the actual damage to the specific insured property in each case (i.e. severe or minor) and the obvious pre loss intentions of both parties.

OEH cuts both ways. It can allow some insureds to get a 'windfall gain' and be in a better position than they would have been if the event had never happened. Conversely, the more devastating and widespread the damage and impact of the event, the more likely it is that the resulting BI claim will be substantially reduced or even eliminated.

It is counter-intuitive that the application of the OEH principles could mean that the greater the widespread damage in a natural disaster event, the less an insurer might have to pay for a BI loss arising from damage for which an insured, pre-loss, made a conscious decision to insure and for which an extra premium was paid.

Worse still, the OEH principles, taken to their logical (or illogical??) conclusion, could be applied to all affected businesses (as often happened in Christchurch), thereby progressively reducing all insurers' cumulative exposure to earthquake BI losses the greater the widespread damage and in this case the impact of the Red Zone cordon.

It's hard to believe this was intended by insurers who, prior to the earthquakes, had sold almost universally in NZ, BI Policies with Natural Disaster Extensions. If such a limited outcome was pre-meditated, serious questions need to be answered by the insurance industry.

Purists will say it is only the insured damage, not its cause that is relevant because that is what the Policy says. In my opinion, cause cannot be ignored without unintended consequences to the outcome of the claim. If the cause is a fire, the *'but for the damage'* analysis to set the standard against which the BI loss is measured must proceed on the basis that no fire had occurred because it was the fire that caused the damage.

With an earthquake, *'but for the damage'* can only mean that there was no earthquake that caused the damage to the insured property and therefore also to the surrounding area. No event and no damage surely implies BAU, in which case competitors and other parties would not have been damaged either and would have been competing more or less normally.

There are two important facets of the Adjustments Clause, or the 'Other Circumstances' or 'Trend' Clause, as it is sometimes called:

- (a) **'Concurrent Cause'**: This means loss caused concurrently by physical damage to the insured property and damage to, or the consequent loss of attraction of, the surrounding area.

(b) **‘Special Circumstance’ or ‘Other Circumstance’**: This means the event giving rise to the insured loss itself is or should be a ‘special circumstance’ or an ‘other circumstance’ for the purposes of the Adjustments Clause and its application to a BI loss.

Some experienced legal practitioners conclude that to allow the event to be an ‘other circumstance’ is to turn the Adjustments Clause into an exclusion clause, which it is not and was never intended to be.

The application of the OEH principles allows Insurers to choose which of two independent causes are best for them because the independent cause not causing the loss would have operated anyway, *‘but for the damage’*. In certain circumstances, that could mean quite correctly, no claim or a significantly reduced claim (e.g. a fire in an overseas supplier’s factory cutting off the flow of goods for sale in the local market), or a significantly increased claim (e.g. a fire in a competitor’s plant, reducing competition and increasing the standard against which the loss is measured). In Christchurch there were not two independent causes. The root causes of all the losses were the earthquakes.

It was interesting that in Christchurch many insurers ‘volunteered’ cover under the Public Authorities Extension without explaining how the cordon resulting from the earthquake had caused loss, but the physical damage from the earthquake to the insured had not. Presumably, it was the result of, or threat or fear of, damage to any property that triggered the closure by a Public Authority?

In many cases in Christchurch the circumstances that gave rise to the Red Zone cordon and lack of access made no difference because insureds could not have taken advantage of business from customers or tenants anyway even if there had been no cordon, due to their own serious damage or destruction.

Some lawyers suggest that in the OEH case, the Court reached its decision by imputing extra words into the policy, namely that *‘had damage not occurred’* was replaced (by implication) with *‘had damage and whatever event caused the damage not occurred’*. This frustrates the proper purpose of the Adjustments Clause. ‘Damage’ to the OEH was caused by the same hurricane that caused ‘damage’ to New Orleans.

Logic and a rational and reasonable view says that if the hotel had not been damaged, then it follows that there would have been no hurricane to cause the damage. Therefore, it follows there would have been no widespread damage in New Orleans either.

It is therefore argued that the Adjustments Clause was intended to consider and should have considered the result if there had been no hurricane. The outcome does not make sense on any other basis. To suggest that the hurricane could have devastated New Orleans, but left the OEH unaffected in the centre of a devastated area is illogical, unrealistic and commercially nonsensical.

That might have been true with Katrina and New Orleans, or perhaps even central Christchurch after the 22 February 2011 earthquake. **However, I am aware of cases of extensive widespread damage with specific examples of no damage within the wide area, even in Christchurch. No damage means no claim, except under the limited cover provided by the Dependency Extensions, if applicable.**

It is difficult to believe that before Katrina, or the Christchurch earthquakes, either insureds or insurers intended such unrealistic and inequitable results. The fact that post loss, each adopted, or could have adopted, such opportunistic positions of financial advantage ('windfall gains') points to the fact that it was not pre-meditated and was never intended.

The position many insurers adopted in Christchurch post loss was a shock to insureds. It is a position I have not applied or seen applied in NZ before the Christchurch earthquakes. The application of OEH cannot produce '*as nearly as reasonably practicable*' the result that would have been achieved, but for the insured damage. The OEH result is unrealistic, hypothetical and non-commercial, suggesting that it is wrong in principle, inequitable and contrary to the principle of indemnity that is supposed to underpin insurance.

I am inclined to think that the real problem is that BI policies are incapable of doing the job they are intended to do in cases of WAD as they are currently constructed.

Insurance practice evolves over time and principles are modified, particularly with BI where there are limited legal precedents. My impression is that current UK market practice in WAD situations is now in the main some sort of negotiated equitable BAU settlement – please tell me if that is not so? Given that in practice outside of Christchurch, insurers in most jurisdictions are apparently not applying OEH, a significant groundswell seems to have developed to try to change BI Policy wordings to better reflect the obvious intentions of the parties.

In practice, this will be difficult without making insurers ‘liable for the world’. The challenge is to develop a wording that precludes ‘windfalls’, but that limits the insurer’s exposure to BI losses resulting from the actual damage to the insured’s own property, plus additional benefits from agreed Dependency Extensions.

To a certain extent, the US market has achieved this with its overt exclusion of windfall gains in some Policies. However, until a change is made to our BI wordings, or at least the Policy shortcomings in the event of widespread natural disasters are disclosed explicitly to an insured, division among practitioners is sure to remain.

Whether the issue is approached from the standpoint of ‘concurrent independent causes’ (one of which is the insured loss) or by the argument that ‘special circumstances’ are events extraneous to the event giving rise to the insured damage, fairness and logic strongly support the view that the clear intention of the Adjustments Clause is to produce an indemnity which puts the insured back in the position it would have been in if the event giving rise to the physical damage had not occurred. With a fire that affects only the insured property, that is exactly what the Policy does and usually quite well (subject to Policy limits). The fact is that in Christchurch the earthquake was the only way the damage could have occurred.

I believe my ‘BAU’ approach still works even in the case of an undamaged business with no primary MD or BI claim that would still have suffered a downturn in business simply because of the negative effect of the WAD on the region and the country, compared with the case of the same type of business suffering significant physical damage.

For the business with no direct physical damage to insured property there would be no primary MD or BI claim.

However, to the extent the BI Policy for that business contained Dependency Extensions, the 'deemed damage' provisions could trigger claims under the Prevention of Access, Acts of Civil Authorities, Utilities, and/or Customers and Suppliers Extensions, subject always to the specified time exclusions and sub limits of cover.

With the possible exception of the Utilities and Customers or Suppliers Extensions, which sometimes specifically preclude aggregation, I see no reason why the individual losses under the other Extensions should not be aggregated (again within Policy sub limits), provided the individual losses can be proven and there is no double counting of those losses. The damaged business would also have a primary claim limited to the notional impact of the damage to its insured property, plus its Dependency claims. Highly subjective, I acknowledge, but more equitable.

The OEH case was a review of an Arbitration award and although it supported the decision of the arbitrators, it is often noted by legal counsel that as an appeal from an Arbitration panel, it was a high hurdle for the Court to overturn the Tribunal's Award. There is no guarantee that another Court would follow OEH if the claim were to be argued directly. I am aware of confidential arbitrations that have not followed OEH.

Perhaps this is why insurers in Christchurch have been reluctant to litigate the OEH principles and compromise settlements have been negotiated in all cases I have been involved with. WAD response and the application of the OEH principles are among the more serious shortcomings in BI Policies that should be addressed for the future to meet insureds' expectations and insurers' intentions in natural disaster situations.

The BI Policy Dependency Extensions

I think it was incorrect for insurers in Christchurch to restrict cover solely to the Public Authorities Extension. The primary cover under a BI Policy is for loss of Gross Profit as a consequence of a shortage of turnover. Standard Turnover should not be adjusted on the basis that damage inflicted by the earthquake would have occurred in any event and would therefore have caused an insured to suffer the same BI loss even if that insured's building had suffered no physical damage in a sea of devastation.

Almost all BI Policies in Christchurch contained Extensions for Prevention of Access, Acts of Public Authorities, Customers, Suppliers, and Utilities and Services. Assuming the Adjustments Clause was applied as I have argued and not as per OEH, the Extensions would be subsidiary to the primary claim for BI loss caused by physical damage to buildings and more likely to apply once the assets were restored and the business re-opened (perhaps notionally with the cordon in place), subject always to the length of the maximum Indemnity Period and the adequacy of Policy limits and sub limits.

On the other hand, if OEH is followed and the insurer is precluded from arguing there is no BI loss caused by any of these other consequences of the earthquake, it ought to be possible to aggregate the Extensions, as happened in the OEH case. Applying the Judge's reasoning in OEH, once it is argued that no loss has been caused by the physical damage to buildings, or that repairs would have ensured that no such direct loss would have continued, it follows that it must be Prevention of Access, Acts of Public Authorities (the Christchurch Red Zone), Utilities and Services, etc, that are the ongoing cause of the loss, i.e. all the effects that would have caused BI loss even if the buildings had not been damaged.

There is no sound reason for disallowing cover under these Extensions or not aggregating them if the type of loss allows, in order to provide the greatest possible protection from the Extensions and within the indemnity limits in the Policy the insured has paid for.

This conclusion is reinforced by the language commonly used for the Utilities and Services Extension, which usually specifically provides that there shall be no aggregation between the Utilities and Services Extension and the Customers or Suppliers Extensions. This restriction in these Clauses suggests that in the absence of such a stipulation in any of the other Dependency Extensions, aggregation is permitted.

BAU

A BAU approach is a combination of an assessment of the loss of Gross Profit for the period required to rebuild the property if it were destroyed, or repair the damage to insured property, then recover the business without artificial restrictions, **plus** aggregation of the additional cover provided by any of the Policy Extensions to the extent there are such identifiable ongoing losses and Policy limits allow.

The fundamental principle is indemnity, no more, no less, with no windfall gains or losses. A broad Loss of Attraction or 'Wide Area Damage' Clause covering damage over a significant geographical region without a sub limit could probably achieve an outcome closer to a full indemnity in a widespread disaster without argument, but such clauses are rare and were non-existent in Christchurch.

A 'BAU plus Extensions' outcome is likely to be a negotiated settlement because I accept that it is almost impossible to avoid completely all impacts of the widespread damage in such an assessment, e.g. scarce resources for reinstatement causing abnormal delays. However, in my opinion, BAU plus Extensions is a more realistic approach that is likely to deliver a more equitable outcome that should not be a surprise to an insured or insurer.

The 'Residual Value' Apportionment of Increased Costs

The second BI issue I would like to talk about concerns increased costs, their eligibility for recovery in a BI claim and their possible apportionment between the Indemnity Period and that period after the Indemnity Period has expired during which an insurer asserts that an insured has benefitted from the increased costs and should therefore contribute to them.

This is the so called 'residual value' or 'enduring benefit' apportionment of BI increased costs between an insured and an insurer. Most insurers endeavoured to impose such apportionments in Christchurch earthquake BI claims because the sheer scale of the damage meant that Policy maximum Indemnity Periods were universally too short and the increased costs were substantial.

Let me explain what typically happened:

- Insurers would usually signal that they intended to apply economic limit strictly and apportion on an undiscounted time/use basis, certain increased costs, usually for temporary facilities and the cost of some items of temporary furniture and office equipment.

- Apportionment would be between the applicable Indemnity Period (or part thereof) and the period outside the Indemnity Period during which an insured continued to use, or often was alleged would continue to use the temporary facilities, pending completion or acquisition of permanent new premises. Typically, insurers would assess unilaterally, usually without consultation and with the benefit of hindsight, the likely period of use outside the Indemnity Period for the purposes of apportionment.

On many occasions I would find myself reminding the insurer of the insured's decisions and actions following the event that led to the increased costs incurred (at least for my clients):

- The insured had always protected its damaged and undamaged assets from further damage after the earthquake as best it was able, given that the insured's premises were often destroyed or uninhabitable and the insured had no access to them due to the catastrophic damage suffered in the insured event. Thousands of buildings were too dangerous to enter and were subject to compulsory demolition orders. Often an insured's plant and machinery, stock, office equipment, records and IT equipment were destroyed with the building.
- The insured had restored and maintained its business, usually surprisingly quickly in some form, often initially from the homes of owners and staff, and later from small, hastily converted and inadequate temporary premises.
- By these means the insured had managed to keep its business operating throughout the Indemnity Period and often maintained significant revenue.
- The insurer was always kept fully informed of the insured's proposed actions, although this advice was not always acknowledged by the insurer or its loss adjuster. At all times the insured acted as a 'prudent uninsured' and made informed mitigation and permanent reinstatement decisions with the assistance of competent professional advisers.
- At no stage had the insured failed to mitigate its losses or to exercise 'reasonable dispatch' in finding and setting up temporary or new permanent premises, but the gravity of the catastrophe, the number of claims and the scarcity of resources meant that Indemnity Periods were often too short and moves back to new permanent premises were delayed until outside the maximum period through no fault of the insured.

- By these means, the insured substantially mitigated its BI claim for loss of Revenue or Gross Profit, which the Policy required it to do, while ensuring its own long term survival and recovery.

Survival and recovery are the primary intentions of any insured with a going concern when it arranges full 'new for old' replacement cover on its assets and full BI cover for its earnings and increased costs in order to provide ongoing protection while its damaged or destroyed assets are reinstated.

Let's come back to the foreshadowed undiscounted time-based apportionment of qualifying increased costs between the Indemnity Period and the period outside the Indemnity Period before the permanent reinstatement was completed.

Proposed Apportionment

The proposed apportionment is based on the insurer's assertion that the insured has benefitted and will continue to benefit outside the Indemnity Period from the ongoing use of usually temporary facilities and should therefore pay for that benefit.

In spite of repeated requests over the past six years since the first Christchurch earthquake, to date no insurer has been able to produce to me an independent and credible authority for such an apportionment.

While in most cases it was true that the insured had continued to occupy the temporary facilities beyond the expiry of the maximum Indemnity Period, no insured set out in 2011 immediately following the damage, with this outcome in mind. In fact at that time, most insureds expected to be occupying their reinstated premises within the Indemnity Period to ensure the survival and continuity of their businesses.

The allocation of increased costs between insured and insurer requires a more subtle analysis of the 'purpose' of the costs incurred ('purpose' being the word the Policy uses to assess the eligibility of an increased cost), which means examining intention (implied by the word 'purpose'), and benefit.

An inflexible and inequitable time-based allocation, applied with hindsight years after the event and based on issues that the insured did not know about and could not have known about at the time the decisions were taken to incur the increased costs, does not consider these critical criteria.

In most cases I rejected an insurer's approach and apportionment because:

- The insurer had received substantial benefit from the loss mitigation actions taken by the insured and which the insured was expected to take in terms of its Policies. The consequent reduction in the potential claim for loss of Gross Profit was significant, obvious and measurable.
- The insured had understood and accepted from the outset that any BI losses from trading or increased costs incurred after the end of the maximum Indemnity Period were uninsured and none had been claimed.
- The insured had not claimed any time-based costs incurred outside the maximum Indemnity Period such as power, equipment hire, etc, in relation to the temporary facilities because those costs were not incurred during the Indemnity Period.
- Any so called 'benefit' that might have accrued from the ongoing use of the temporary facilities was unintended and unforeseen by the insured at the time the costs were incurred. That so-called 'benefit', which accrued months and years later, was merely an incidental, unintended and unforeseen consequence, firstly of the decisions to mitigate taken in the weeks and months following the event and secondly, of subsequent events that could not have been foreseen at the time the decisions were made and costs incurred.
- When the insured was making these mitigation and business continuity decisions to '*avoid or diminish*' its loss of turnover and '*resume or maintain*' its normal operations, it did not know for how long or even if its temporary facilities would be required beyond the Indemnity Period. At the time, most insureds reasonably believed their replacement permanent premises would be repaired or rebuilt within the Indemnity Period.
- If the temporary facilities been consciously designed and built from the outset to survive for a known time beyond the Indemnity Period (which rarely they were), then apportionment of the temporary costs to reflect that decision would have been appropriate.

- An apportionment is not appropriate when the insured did not know when or how permanent reinstatement would occur. Timing was not a consideration in the insured's decisions relating to temporary facilities. The focus was on restoration of business in the shortest possible time in order to mitigate trading losses and ensure survival and continuity.
- Intention or 'purpose' can be judged only against what the decision maker knew at the time the decision was made, not judged months or years later using hindsight to second guess that intention or purpose and create an intention or 'purpose' that was never contemplated by anyone at the time. It is not reasonable or equitable to use hindsight to impute different post Indemnity Period 'purposes' or intentions into decisions taken by Insured in good faith soon after the catastrophic event many months or even years before.

Increased Costs and the BI Policy

Provided the increased costs incurred were '*additional*', '*reasonably incurred during the Indemnity Period in consequence of the Damage*', and were the minimum that could have been invested '*to avoid or diminish a reduction in Turnover and/or resume or maintain the normal operation or service of the Business*', the costs are recoverable, subject to Policy limits.

BI Policies do not contain specific provisions for so-called 'residual value' or 'enduring benefit' contributions to costs from insureds. The definition of eligible 'additional expenditure' under the Gross Profit Item incorporates reference to the additional expenditure having to '*avoid or diminish the reduction in Turnover, which but for that expenditure, would have taken place during the Indemnity Period*', with a monetary cap on the increased costs of the loss of Gross Profit avoided by incurring those costs. This is the 'economic limit' for increased costs claimed under the Gross Profit Item.

Provided the costs incurred meet these criteria, the insurer has received the full benefit of what it asked for and the costs should be accepted as part of the BI claim. The insurer cannot, after the event, try to incorporate into the Policy some further concept of apportionment of increased costs that was not in the Policy before the loss.

Finally, insurers were reminded that if insureds had not taken the actions they did after the loss of their premises the outcome could have been devastating to their businesses and much more costly to insurers in terms of a loss of turnover and Gross Profit. Ironically, if these insureds had done nothing and lost substantial additional revenue and Gross Profit (which they would have claimed), insurers could probably have raised questions as to whether the insureds had done everything they could reasonably have done to mitigate their losses, as they were obliged to do under their Policies.

Insurers cannot have it both ways.

The 'Sole Purpose' Test

Increased costs claimed under the primary cover provided by the Gross Profit Item are subject to the so-called 'sole purpose' test. To be eligible for recovery as part of the BI claim the Policy states that an increased cost claimed under the Gross Profit Item must be incurred for the 'sole purpose' of *'avoiding or diminishing the shortage of turnover that but for that cost, would have occurred during the Indemnity Period'*.

It has long been accepted by BI practitioners, insurers and the Courts that almost no expense eventually meets a 'sole purpose' test, particularly when viewed with hindsight. It is the dominant 'purpose' or intention at decision time that is most relevant and of paramount importance in determining eligibility. Numerous incidental 'purposes' for a cost inevitably emerge later that were not considered at the time the cost was incurred.

For example:

- Temporary repairs that provide continuity of business immediately following a loss and only within the Indemnity Period, also protect the long term goodwill of customers and ensure a business goes on receiving revenue long after the Indemnity Period has expired. Such costs have always been accepted by insurers without question, adjustment or apportionment.
- Additional wages and overtime to keep the business trading in the short term invariably protect goodwill and revenue in the long term, but are never apportioned between an insured and insurer.

- A lease for temporary premises for a minimum term of say 2 years when the premises were required for only the 12 month Indemnity Period. Landlords will often not agree to temporary occupancy on any other basis. In such cases it is accepted that the full 2 year cost is claimable within the 12 month Indemnity Period with no apportionment because the 2 year cost was unavoidable ('reasonable and necessary') and was incurred during the Indemnity Period when the lease was signed.

It is necessary to test that the costs incurred for temporary facilities were, as far as was reasonably practicable, for the minimum possible scope of works consistent with achieving an outcome that ensured the temporary facilities would actually function. They were expected to be the cheapest temporary accommodation solutions that would allow the business to operate successfully and also be acceptable to customers and staff. Anything less and the temporary solution would not have been effective and could have impaired, not enhanced the performance of the business. Anything more could have been construed by the insurer as a failure to discharge the obligation to do everything reasonable practicable to mitigate costs and losses.

The minimum scope meant that the temporary works were executed the same way whether they were to be used for 6 months, 12 months, 2 years or 5 years. In other words, the possible life of the temporary facilities beyond the end of the maximum Indemnity Period was simply an unavoidable consequence of ensuring the temporary arrangements would be effective at all during the Indemnity Period. Lifespan of the works was never an objective in itself.

There was never any intention that the temporary facilities would be permanent. They were not unnecessarily over-designed to ensure they would remain effective beyond the maximum Indemnity Period or to become part of the permanent reinstatement.

I have had cases where temporary facilities were constructed too cheaply at the outset and failed during the Indemnity Period before new permanent premises were available. They had to be rebuilt temporarily, generating additional claimable increased costs.

Summary of my position on the 'residual value' apportionment of increased costs:

An insured's position in respect of the increased cost of the temporary facilities may be summarised as follows:

- Continuity of supply of goods and services, and the maintenance of critical relationships with customers are fundamental to an insured's business and its survival and continuity.
- An insured buys replacement insurance on assets and BI cover on earnings to ensure survival and continuity following an adverse insured event. That was its expectation before the earthquakes and the basis of its claim after the event.
- As part of achieving survival and recovery, an insured is entitled to, indeed compelled to, develop plans to execute permanent reinstatement with reasonable dispatch while maintaining continuity of operations as best it can. 'Reasonable' must be judged in light of the wider circumstances of the loss.
- It is not equitable, or authorised by the Policy, for an insurer to use hindsight to impute different post Indemnity Period 'purposes' or intentions into decisions taken by an insured in good faith immediately following the catastrophic insured events.
- An insured's 'purposes' or intentions must be judged on the basis of what the insured knew at the time decisions were taken.
- An insurer is entitled to ask if under the circumstances, the insured acted reasonably. 'Necessarily and reasonably incurred' in relation to an increased cost are linked to the 'purpose' or intention to avoid or diminish a reduction in turnover that would otherwise have occurred during the Indemnity Period in consequence of the Damage.
- 'Necessarily and reasonably', or just 'reasonably' with Additional Increased Cost of Working, must be read and judged, and the purpose or intention evaluated, based on what an insured knew or intended at the time the decision was made.
- Notwithstanding the word 'sole' attached to the word 'purpose', no cost is actually incurred for a 'sole' purpose.

- Further protection is provided by the Additional Increased Cost of Working cover where the test is only *'reasonably incurred during the Indemnity Period'*, without reference to *'sole'* purpose and where the additional costs may simply be incurred *'to resume or maintain normal operations and services'* without an economic limit test. Policies containing a substantial separate Additional Increased Cost of Working Item greatly strengthen an insured's cost recovery options.
- An insured's decision does not have to be the best or only way of achieving the *'purpose'*. It simply has to be a reasonable way to achieve a reduction in the loss of turnover or restoration of normal business. That is what the Policy asks for and that is what insurers are entitled to expect. Additional costs that contribute to a significant reduction in the loss of turnover and substantially restore and maintain normal operations, achieve their stated *'purposes'* as required by the Policy.
- Costs are *'incurred'* when an irrevocable liability is taken on, not when payment is made. A simple commitment might be triggered by the receipt of an invoice. However, larger commitments must be examined on a case by case basis and often assembled in logical blocks of expenditure. The timing of incurring a liability and the grouping of expenditure can be important to an accurate economic limit calculation.

'Residual value' is a misleading term. If it means the intrinsic value of an asset at a point in time, e.g. a salvage value at the end of an Indemnity Period, then it is valid for an insurer to expect a credit for that salvage value against the related gross increased cost. This has been an accepted deduction in practice for many years. In practical terms, this would mean that the insured effectively *'buys'* the temporary items at their salvage values at the end of the Indemnity Period.

In my 40 years of BI insurance claims, I cannot recall a case of so-called *'residual value'* apportionment in a BI claim before Christchurch. Adjustments have always been limited to deductions for salvage as described above and in my opinion that is all that should happen.

CONCLUSION

As a loss adjuster in the late stages of my career and working life, it has been an amazing experience to participate in an insured natural disaster the magnitude of Christchurch. It has confirmed my long held belief that you never stop learning. I have learned more and researched more than at any other time throughout my career.

It has been a privilege to live and work with the people of Christchurch for the past 6 years. Their courage, stoicism and determination to rebuild their city has been humbling.

In most cases, I believe the support of our industry and the many other professions and contractors has been honest, hardworking and compassionate, tainted by some regrettable examples of unprofessional and unethical behaviour.

Often the long delays and technical inconsistencies were simply a reflection of the relentless and overwhelming nature of events and the impossibly large number of claims, too great for a small and remote country like NZ to manage. However, we could do better. Let's hope we all learn from the experience.

I'll finish by saying that we could have done without:

- Risk Worldwide and World Claims from the US. Their aggressive and litigious approach had no place in a country like New Zealand.
- Previously unheard of law firms who overnight became 'insurance experts' and gave advice that I knew, as a non-lawyer, was wrong.
- Unscrupulous and sometimes downright dishonest contractors and consultants helped no one but themselves.
- The heavy handed bureaucracy of central Government.
- Grandstanding and infighting between local and central bureaucracies at the expense of people who had lost everything.

- A lazy and sensational media, more interested in the sound bite than accurate reporting.

Christchurch will never be the same again. There will be emotional and financial distress for perhaps another decade before all disputes are settled, claims paid and most of the rebuilding completed.

In the long term, one can only hope that the city is allowed to grasp, and will grasp, the unique opportunity to re-invent itself as an attractive place to live in NZ.

Peter Faire

14 September 2016