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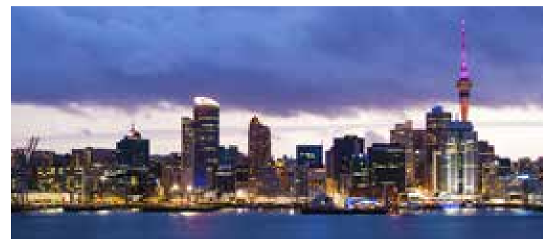

Leaky Building Claims in New Zealand—Some Insurance & Reinsurance Issues

by Nicholas Zambetti, Gen Re, Sydney

Leaky building issues have plagued the New Zealand building sector since approximately 1994. In 2004 the New Zealand Building Act introduced a licensing regime for builders, and building designers, and subjected Councils to regular quality control. It also introduced changes to the Building Code. However, the legacy of the problems will be around for years to come, with thousands of affected properties, mainly homes and apartments–still requiring extensive repairs.

On 12 October 2016 *The New Zealand Herald* reported that New Zealand's biggest leaky building case was about to begin in the courts.[1] It is said to involve a claim of some NZ 40 million in relation to an apartment complex in Auckland.

What are some of the issues and hurdles in insurance and reinsurance claims arising from leaky building problems when they involve liability and professional indemnity covers? I take a quick look at some of them here.

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About This Newsletter

Created for our clients, our *Insurance Issues* publication provides an in-depth look at timely and important topics on insurance industry issues.

Limitations and Triggers

Many of the issues revolve around the insurance policy cover limitations and triggers. In the reinsurance context, this means not only how and when which losses attach to which reinsurance covers but also the extent to which losses that may seem to be inter-related can be aggregated. A myriad of parties are often involved in these disputes—from the initial building designers to the Councils to the builders, and individual contractors.

When it comes to the parties covered by professional indemnity insurance, the policy trigger will generally be the date the claim was first made on the professional, assuming the professional had no prior knowledge of circumstances which could give rise to such claim (as that will complicate coverage—a discussion for another day).

In turn, the reinsurance cover in force at the time of the policy inception date of the triggered policy will generally determine the treaty cover that covers the insurer. This is referred to as a *Risks Attaching* trigger.[2]

So far this seems clear, at least if we put aside for a moment the issue of possible aggregation of policy claims or reinsurance claims.

Liability, Coverage and Triggers

With leaky building claims, once we start moving away from professional indemnity covers, the situation becomes more complex, largely due to both the primary policies and the reinsurance covers tending to be triggered by *Occurrences*; hence they are triggered on a *losses occurring* basis. I will return to this issue shortly.

> "How do we pin down when the damage occurred? ... Is it when damage has first manifested itself and come to the attention of the property owner?"

Contrary to some common misconceptions, builders and contractors are generally not covered for faulty products or faulty workmanship under their public liability policies. (Many homeowners would be alarmed if they were aware of this and would probably review their choice of builder and the builder's financial standing if they were so aware.) However, the result may well be that the cost of remedying such defective products and/or work falls to the builder/contractor, who may be impecunious.

What is generally covered under such liability policies are the costs of remedying any *resultant property damage* caused by the faulty products or workmanship. For example, if there is defective cladding or defectively installed cladding that has allowed water ingress and thus caused timber and wall lining to decay/become damaged, the cost of replacing the timbers and wall linings would be resultant damage and would be covered. The cost of replacing the defective cladding itself would not be covered.

What often happens, however, is that the water ingress does not come to the notice of anyone for some time, and sometimes not for years, until there are obvious and overt signs of water leaks or damage, such as deteriorated wall linings.

Pinning Down the Occurrence Date

Liability policies are triggered by *physical damage occurring during the period of insurance*, but as the above example suggests, how do we pin down when the damage occurred?

- Is it when the faulty products were installed or the work completed?
- Is it when the project is completed and there has been a handover of the work to the Principal, i.e., practical completion?
- Is it when water ingress was first noticed?
- Is it when damage has first manifested itself and come to the attention of, for example, the property owner?

This last question is a vexed question, and one which the New Zealand courts have grappled with. New Zealand's leading leaky building case on this point is *Arrow v. QBE*.[3] Without reciting all the facts, in essence at the time insurer QBE came on risk, leaking was already occurring; further damage did occur, and damage first manifested itself during QBE's policy period.

However, the point at which damage was deemed to have occurred—and indeed the point where the damaging effects of continued leaking was not causative of additional compensable loss—was considered, and it was determined that:

- Legal liability occurs not when the leaking first occurs, nor when the damage first becomes manifest.
- Each case must be considered on its own facts to determine *"when an alteration to the physical state has occurred which is more than de minimis*[4] *so that the point has been reached where physical damage has happened"*.[5]
- Absent any expert advice specific to the circumstance of a case which can more precisely opine as to the likely period that damage occurred, it is deemed to occur within 6–18 months of completion of the work. In *Arrow* it was agreed that once a building starts to leak, there will be enough moisture in the wood to promote fungal growth within three to six months. During the next six months, decay will advance so that it is well underway, such that the strength of the wood is compromised. Physical damage, in terms of the policy, has occurred by then.

It can therefore be seen that mere first manifestation of damage is not the relevant test to apply when considering whether and when a liability policy might be triggered. This is consistent with general principles of the law of tort; namely, that liability arises upon the occurrence of damage, which is the *gist of the action.* Similarly, once substantial damage has/is deemed to have occurred, which might already require total replacement or amount to a total loss, then any continued exposure to leaking cannot be said to cause any further compensable damage. In *Arrow*, QBE successfully declined the claim on the basis that, while the damaging process of leaking continued after QBE came on risk, the wood had already rotted to such an extent that it was not going to cost the owners any more to remedy that further damage.[6]

The Interplay of Liability, Coverage and Aggregation Issues

Insurers face complexities when they receive leaky building claims. Determining whether there is cover and if so, which of several progressive yearly polices might be triggered, is never straightforward. Leaky building exclusions, which insurers started including in their policies 5–10 years ago to help shield them from such claims, provide greater impetus for cover to be founded in earlier, pre-exclusion policies.

The smaller size of the New Zealand market, and the fact that these disputes invariably drag in any party involved in the whole construction process, means that insurers can be faced with multiple exposures arising from the same project. Coupled with the fact that multi stage, multi-unit developments are often also involved, insurers can be faced with significant exposures when the sum of claims received are accumulated, and impecunious or uninsured parties effectively leave the exposure to the insured parties pursuant to the sometimes inequitable effect of joint and several liability.[7]

In a multi-unit, multi-stage development, for example, completion of various units may take place progressively over two or three years, even though there may originally have been one initial, large contract in respect of the whole development. If numerous units appear to have similar defects—with respect to the work of a particular contractor undertaken over a long, staggered period—that caused leaks and building damage, what is the date or dates of damage? How many primary polices are triggered? What reinsurance covers are triggered and what, if any, accumulation of claims can take place for the purpose of maximising reinsurance recoveries?[8] Do they all arise from the one event for the purpose of liability covers?[9]

English case law, which we need to examine for some guidance on this, tells us that an "event" is something that happens at a *particular time, at a particular place, and in a particular way.*[10] In addition a causal link is required between any individual losses sought to be aggregated. Leaking that has taken place over a long period of time is more akin to a *continuing state of affairs rather than an event.*[11]

The issue of what constitutes an event is also highly dependent on the wording of the reinsurance aggregation clause. Here it is instructive to distinguish between more common event-based aggregation clauses and cause-based aggregation causes, as the latter offer greater scope for aggregation.[11]

These issues can be complex and straddle grey territory. However, if we try to apply the above principles, the answers are dependent on some of the following considerations:

- ✓ Whether the same type of work was done in the same way and was completed at the same time on several units/properties on the same project.

> From that perspective, one might argue that it's necessary to look not just at the date of Contractual Practical Completion of the Project or Project Stage, but the date of physical completion of the work the cause of the problems, as on and from that date, the process of water ingress could commence, leading to eventual damage.

- ✓ When the damage is deemed to have occurred, rather than when it first became manifest.

- Whether the damage occurred within the same policy year and/or reinsurance cover period.
- The wording of any policy and reinsurance aggregating clauses, if any.

How an insured and/or insurer may wish to structure their argument will also be dependent on the size of the policy limit, the existence of any annual aggregate policy limit, and whether several yearly policies might be capable of being triggered. Similarly, from a reinsurance recovery perspective, the insurer may or may not find it beneficial to rely on a loss aggregation clause.

Fortunately, in our experience reputable insurers in the Australian and New Zealand markets come to the reinsurance negotiating table with a fairly transparent and sensible commercial approach to these issues, such that most can be resolved by analysing the facts and applying them to the covers as objectively as possible. ■

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Endnotes

1 http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11727379.

2 Also known as a *Policy issued/renewed* trigger; i.e., claims accepted by an insurer on a policy incepting during the treaty period. Note too that less often, the trigger under the reinsurance cover can also be pure *Claims Made*; i.e., claims first made on the insurer by the insured during the treaty period (as opposed to the policy period).

3 *Arrow International Ltd v. QBE Insurance (International) Ltd [2010] NZCA 408.*

4 Latin, meaning more than of a trifle nature.

5 Per MacKenzie J, in *Arrow International Ltd v. QBE Insurance (International) Ltd—[2009] 3 NZLR 650*.

6 Ibid.

7 Compare this to the Proportionate Liability regimes introduced in Australia under the Civil Liability Act 2002 in NSW and similar statutes in other State jurisdictions. See the history and effect of this legislation discussed in:

a) Proportionate Liability, by Damian McNair, PWC: http://www.pwc.com.au/legal/assets/investing-in-infrastructure/iif-42-proportionate-liability-feb16-3.pdf

b) Proportionate Liability—Dividing the Construction Industry, by Andrew Hazer, Mills Oakley: http://www.millsoakley.com.au/docs/Proportionate%20Liability.pdf

8 Accumulation or "aggregation" of claims under a reinsurance treaty, for example, might occur if it can be argued (subject to the wording) *that each and every loss or series of losses arose out of one Event*. If so they might be deemed to constitute one Loss Occurrence and hence be subject to the application of a single reinsurance retention.

9 Note that whereas reinsurance cover often provides a reinsurance limit *per event* for public liability covers, such Limits are often *per claim (per policy)* on the insurer under Professional Liability covers, thus providing greater protection to insurers.

10 See *Axa v. Field [1996] 3 All ER 517*.

11 See further discussion in *Aggregation in Insurance & Reinsurance Contracts, J Edmond, 2009: https://www.allens.com.au/pubs/pdf/insur/pap3jun09.pdf.*

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