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Case Alert

Shaping the future of insurance law

High Court determines leaky defect exclusion

Napier City Council v Local Government Mutual Funds Trustee Limited **[2021] NZHC 1477**

15 JULY 2021

AT A GLANCE

- On 21 June 2021, the High Court handed down its first substantive decision on the application of a leaky defect exclusion against a mixed defect claim in *Napier City Council v Riskpool*.
- The matter involved Napier City Council's contest of a declinature by the local mutual liability scheme (Riskpool) for a defective building claim for Waterfront Apartments.
- Riskpool relied on a leaky defect exclusion. It was intended to limit Riskpool's risk where any weathertight defect allegations were made by excluding cover completely. When asked to strike out the claim, the High Court and Court of Appeal were cautious about the exclusion's application this way.
- After trial, the High Court agreed with Riskpool and read the exclusion widely.
- The Court also accepted that the *de minimis* doctrine applied, allowing cover to remain in extreme cases.
- The Court further held the Council was under a duty of good faith to disclose its (contrary) opinion on the exclusion's application before the policy was placed.
- This significant decision provides guidance for insurers and insureds on an increasingly common and fraught issue.

Background

The owners of Waterfront Apartments issued proceedings against the Napier City Council (Council), and others, alleging a variety of weathertight and non-weathertight building defects.

At the time the Council was a member of Riskpool, which entitled it to cover under Protection Wording with Riskpool's exercise of discretion for further cover. Membership and cover were renewed annually.

Two years earlier, the Council had notified a similar claim that Riskpool declined on the basis of a weathertight defects exclusion. The Council did not contest that declinature.

Despite accepting the earlier declinature, the Council sought cover under the scheme for the Waterfront Apartments' claim. Riskpool declined, again based on the weathertight defects exclusion.

The exclusion

Riskpool's leaky defect exclusion (Exclusion 13) provided: "This Section of the Protection Wording does not cover liability for Claims alleging or arising directly or indirectly out of or in respect of [weathertight defects]".

Exclusion 13's application turned on the meaning of "Claims" and whether a single legal proceeding for multiple defects could be treated as more than one claim. The word "Claim" was defined as "the demand for compensation made by a third party against the Member".

The Council argued the demands for compensation for the weathertight defects and the demands for compensation for the non-weathertight defects were separate "claims". Accordingly, the Council argued that "Claim", as used in Exclusion 13, excluded weathertight defects but did not exclude non-weathertight defects. It also expressed the view that an exclusion that wholly excluded cover for both weathertight and non-weathertight defects would produce unfair results.

In contrast, Riskpool argued for a literal interpretation of the exclusion.

Riskpool said the use of the plural, "Claims", must include the demand for compensation. The number of demands for compensation turns on the facts of the case, and is not tied to the statement of claim or the causes of action.

Riskpool further argued that where there is only one demand for compensation capturing weathertight and non-weathertight defects, the demand is excluded.

To avoid the alleged unfair results, Riskpool appealed to a *de minimis* threshold: so that where the weathertight defects are such a minor or nominal part of the claim that they make no material difference.

Riskpool also argued emails, correspondence and dealings between Riskpool and the Council and its broker demonstrated their mutual understanding of Exclusion 13's meaning and application.

An objective interpretation

The Court took the well-accepted approach that contracts, including insurance contracts, are to be interpreted objectively. This includes using the ordinary and natural meaning of language in the context of the whole contract,[1] and drawing on wider context if there is uncertainty.[2]

The High Court considered that the objective meaning of Exclusion 13 could be determined from the text of Exclusion 13 and in the context of the contract (contrary to the Court of Appeal's earlier view on strike-out). It did not consider comparison with other exclusions in the contract assisted interpretation. The Court agreed with the Court of Appeal that the contract's exclusion sectionwas "a bit of a mess", as exclusions had been inserted "as a cut and paste exercise" with no apparent thought[3].

In considering the ordinary and natural meaning of "Claim" in Exclusion 13, Grice J:

- stated "The pleadings do not determine what constitutes a claim although they may add colour and character" – in other words the underlying facts, and not a statement of claim, should determine an insurer's liability
- affirmed "Claim" should be interpreted widely, as it was in *Thorman*[4] where the notification of demand concerning one building with separate dwellings, subject to multiple defects, constituted a single "Claim" despite specifics of the allegations being supplied later, and
- was satisfied that Exclusion 13 was governed by 'liability for Claims", so that any demand for compensation for a breach of professional duty alleging, directly or indirectly, weathertight defects would taint the demand as a whole for the purposes of cover.[5]

> **The Court took the well-accepted approach that contracts are to be interpreted objectively.**

[1] *Firm PI 1 Ltd v Zurich Australian Insurance Ltd* [2015] 1 NZLR 432 at [63].
[2] *Firm PI 1 Ltd*, above, at [63].
[3] At [94].
[4] *Thorman v New Hampshire Co (UK) Ltd* [1988] 1 Lloyd's Rep 7 (CA).
[5] At [164].

Extreme examples

The High Court's objective interpretation of Exclusion 13 might appear to run counter to the Court of Appeal's observations in the earlier strike-out application.

When considering the strike-out appeal, the Court of Appeal was not prepared to interpret the exclusion in isolation and questioned whether the parties intended the "heady consequence" that a claim based on a structural defect, which would be covered, suddenly becomes uncovered because a plaintiff tips a minor weathertight complaint into the Claim.

The High Court, however, was prepared to accept that a reasonable person with the information available would have understood Exclusion 13 to apply in the way Riskpool contended.

The High Court also accepted that the *de minimis* doctrine applied, either as a matter of law or by implied term. A term could be implied as Riskpool had absolute discretion to provide cover beyond strict application of the terms. The Court commented that while the *de minimis* threshold needs to be assessed objectively in every case, the threshold is so low in most instances that it *"should not present any difficulty"* to see it.[6]

Supporting evidence

While ultimately the Court found it was not necessary to assess the evidence found in the correspondence, reports and dealings, it held that this evidence was admissible and that it supported Riskpool's interpretation of Exclusion 13.

The Court assessed the admissibility of this evidence by applying the usual objective test of mutual intention — whether a reasonable person who was aware of the "commercial or other context in which the contract was made and of all the facts and circumstances known to and likely to be operating on the parties' minds", would have known the information was available or would have been made available.[7]

The admissible evidence included the evolution of the Protection Wording, including revisions made between its 2006 introduction and the 2011 "final" version. Admissible evidence also included Riskpool's annual reports, materials accompanying or explaining the revised terms, and the 2012 declinature made by Riskpool under Exclusion 13.

Inadmissible evidence was found to include communications between Riskpool and its reinsurer, internal Riskpool communications and evidence concerning a separate asbestos exclusion.

From the admissible evidence, the Court concluded that "the reasonable and properly informed person that the Court embodies" had sufficient information to know that the intention behind Exclusion 13 was to narrow Riskpool's risk. This led it to ultimately support Riskpool's interpretation.

Duty of good faith – a positive duty to disclose

The Court noted that the renewal of each period operated as a new contract. The 2012 declinature was not, therefore, evidence of subsequent conduct regarding cover for the Waterfront Apartments, as cover was sought under the 2014 period.

The 2012 declinature was made for the same reason as the Waterfront Apartment declinature — as the claim involved weathertight defects, the whole claim was excluded. At the time Napier City Council did not contest the declinature. It instead decided to "quietly bide its time" for a better claim to contest the interpretation. That decision was to its detriment.

The Court found that the Council was under a positive duty of good faith to disclose that it did not accept Riskpool's expressed basis of cover and interpretation of the weathertight exclusion before renewing its membership in the years that followed. In other words, the Council "could not keep its powder dry for a better case".[8]

The Court considered that, had Riskpool known of the Council's intended meaning at the point of renewing, Riskpool would have likely reassessed the risk of covering the Council and refused to renew or repriced the risk. The Council then would have chosen to renew on the meaning ascribed or chosen not to renew and insure elsewhere. The Court found the Council, by staying silent, was bound as if it had intended to agree Riskpool's meaning of the terms.[9]

[6] At [172].
[7] At [176] to [185], referring to *Vector Gas v Bay of Plenty Energy Ltd* [2010] 2 NZLR 444 (SC) at [19].
[8] At [317].
[9] At [317] and [322].

Conclusion

Napier City Council v Riskpool has broad implications for exclusion clauses that try to exclude an entire claim based on the existence of certain elements and the use of the *de minimus* doctrine to avoid arguments of "heady consequences".

The Court has confirmed the authorities that caution against subdividing proceedings or demands into causes of action or particulars. However, as there is no bright line test to determine whether a proceeding should be treated as one claim, judicial decisions will continue to be based on the underlying facts. We also expect the application of the *de minimis* principle will be an area ripe for future coverage disputes.

This decision also provides guidance on what will be considered relevant and admissible evidence. This will continue to involve the question of what was available to the parties at the time.

However, underwriters and brokers should be aware that terms revisions, accompanying materials, emails, advices and decisions on cover are likely to be considered admissible evidence in an interpretation dispute.

The Court has arguably expanded the law of material disclosure with this decision, by holding that an insured's obligations of good faith extends to disclosures of an intention not to accept a meaning asserted by an insurer on renewal. This potentially expands material disclosure to include a state of mind or opinion. However, it should be noted this aspect of the decision was expressly not determinative, as similar evidence supported Riskpool's interpretation.

We expect the High Court's decision will be appealed, and will report on further developments.

Need to know more?

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