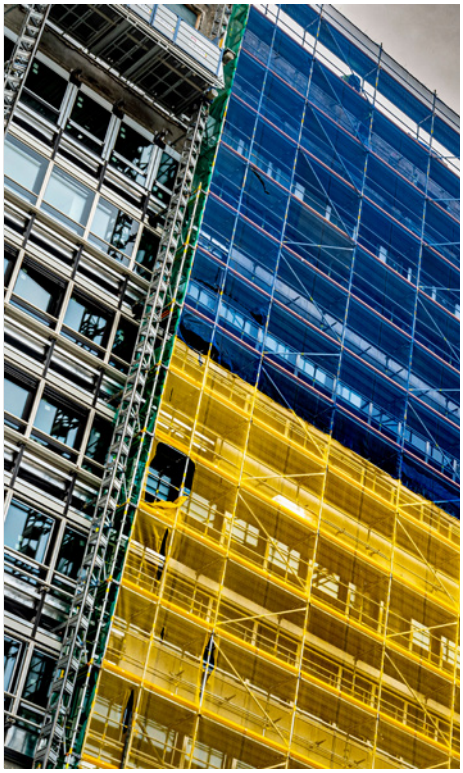
HERBERT SMITH FREEHILLS

# POLICYHOLDER INSURANCE HIGHLIGHTS

## 10TH EDITION

## In this issue






# Introduction

Welcome to the 10th edition of Herbert Smith Freehills' Policyholder Insurance Highlights.

In this publication, we have pulled together the key takeaways for insurance policyholders, their brokers and claims advisors from the most relevant insurance cases and market developments over the last 12 months. This includes topics such as notification, non-disclosure, policy construction and COVID BI claims.

The main messages this year are:

- *AI and the emerging risk landscape*: the most talked about topic in insurance and legal risk this year has undoubtedly been the emergence, and increasing sophistication, of AI technology. In this edition, we explore the risks and opportunities associated with AI, the potential exposures it may give rise to and the role insurance has to play in managing the risks.
- *A growing body of LEG defects cases*: internationally there is now a growing body of case law in relation to the LEG defect clauses used to exclude costs relating to defects in Contract Works/ Construction All Risks insurance policies. In light of several recent cases (particularly in the United States) we have brought together a summary of the law and recent developments for those with an interest in this area.
- *Directors' & Officers' insurance market continues to recover*: despite an uptick in regulatory focus on director/officer misconduct relating to reporting on environmental sustainability (and ESG generally) and a continued emphasis on technological and operational resilience (including cyber resilience), the market for D&O insurance continues to soften in line with recent trends. Premium reductions and enhanced coverage do not appear to be a function of an actual or perceived reduction in class action or director risk, but rather changing insurance market dynamics as new entrants to the market continue to compete for premium and market share.
- *Construction claims on the rise*: consistent with the significant amount of infrastructure and construction investment over recent years, professional indemnity, contract works and general liability claims have been a major feature in 2024 as borne out in various case summaries in this edition. The issues of policy interpretation raised in a number of these recent decisions are highly topical and include important lessons for policyholders, brokers and claims advisors operating in these areas.

We hope that you find this year's edition of Policyholder Insurance Highlights insightful.

Please contact a member of our Insurance team (details at the back of this publication) if you would like to discuss any of the cases or trends and how they may impact your business.

**Anne Hoffmann**
Partner
T +61 2 9225 5561
anne.hoffmann@hsf.com

**Guy Narburgh**
Special Counsel
T +61 2 9322 4473
M +61 447 393 645
guy.narburgh@hsf.com

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# AI and insurance: The emerging risk landscape

The most popular topic in insurance and legal risk this year has undoubtedly been the emergence, and increasing sophistication, of Artificial Intelligence (**AI**) technology.

AI has the potential to transform our lives and our economies. The rapid uptake of AI by businesses is creating enormous opportunities to improve productivity, increase efficiency and unlock value for clients and consumers. The benefits are already being seen through the power and convenience of ChatGPT and other large language models through to increasing efficiency and automation across a range of traditional industries, including financial services, manufacturing, healthcare and education.

However, as with any new technology, new risks are constantly emerging that will require careful assessment and continuous management. These risks cover the full scope of operational, commercial, and regulatory aspects of businesses and have the potential to create significant losses and liabilities. As it always has, insurance will continue to play a crucial role in mitigating the financial impacts of these exposures.

This article covers the following topics:

1. **The emerging AI risk landscape**
2. **The role of insurance in mitigating AI risk**
3. **Looking ahead**

## The emerging AI risk landscape

*What is AI?*

The Oxford Dictionary defines AI as "*the capacity of computers or other machines to exhibit or simulate intelligent behaviour*" and "*software used to perform tasks or produce output previously thought to require human intelligence.*" In essence, it is a form of technology that allows computers and machines to simulate traditional human intelligence.

At its logical extreme, AI may one day theoretically be able to learn and perform any task that previously required human intelligence to complete. AI technology is, perhaps thankfully, not yet at a stage of sophistication where it can simulate all, or even most, forms of human intelligence, but it is certainly taking great leaps forward at a rapid pace.

*Is AI currently regulated?*

AI is already widely used in the economy and is being adopted by businesses at an astonishing pace. The pace of AI's development has left governments and regulators rushing to keep up. The result is that, until relatively recently, there was very little, if any, specific regulation of AI in the major jurisdictions around the world, including in Australia.

The EU recently enacted a comprehensive AI regulation through the introduction of the *Artificial Intelligence Act* in August 2024 (**EU AI Act**). The EU AI Act classifies AI systems according to the following categories of risk:

- **unacceptable risk**: AI systems which pose a clear threat to people are **prohibited**, such as cognitive behavioural manipulation of people or specific vulnerable groups (eg voice-activated toys that encourage dangerous behaviour in children) and social scoring systems (eg classifying people by reference to behaviour) and biometric identification of people, including facial recognition (except by law enforcement);
- **high-risk**: AI systems that negatively affect safety or fundamental rights are considered high risk and **subject to strict obligations** before they can go to market;
- **limited risk**: AI systems that make it possible to generate or manipulate images, sound, or videos (including 'deepfakes') are **subject to transparency requirements** so that individuals are aware when they have been used; and
- **minimal risk**: AI systems that are already widely in use, including systems used in video games, spam filters and inventory management. These systems are **not regulated**, but a voluntary code has been suggested.

General purpose AI models (such as ChatGPT) are subject to transparency requirements and must provide technical documentation, instructions for use, comply with the EU's Copyright Directive, and publish a summary about the content used for training. If a general purpose AI model exceeds certain computing power thresholds specified by the EU, the provider of the model must notify the EU and demonstrate that the model does not present systemic risks.

In 2024, the Australian Government conducted a consultation process on a "*Proposals Paper for Introducing Mandatory Guardrails for AI in High-Risk Settings*" which set out three proposed regulatory approaches to address the risks of AI:

- adopting AI guardrails within existing regulatory frameworks as needed;
- introducing new framework legislation to adapt existing regulatory frameworks; or
- introducing a new cross-economy AI-specific law (for example, an Australian AI Act).

The consultation completed in October 2024 and the government is presently considering the responses to inform next steps on AI regulation.

The government has in the meantime released a new Voluntary AI Safety Standard for use by Australian businesses. In step with similar actions in other jurisdictions – including the EU, Japan, Singapore, the US – the intention is that the standard will be updated over time to conform with changes in best practice.

On 29 October 2024, ASIC also released a report entitled "*Beware the gap: Governance arrangements in the face of AI innovation*" urging financial services and credit licensees to ensure their governance practices keep pace with their accelerating adoption of AI. AI risk is therefore likely to be a key focus area for regulators over the short to medium term.

*What risks are associated with the use AI?*

The reason why new regulation has come about is that AI can be both unreliable and even potentially harmful if it is not properly supervised. For example, AI is well known to be susceptible to several limitations and issues including:

- **Model drift**: when an AI model's performance degrades over time due to changes in data distribution, the operating environment, or even the model's goals or objectives, requiring monitoring and updating or retraining the model;
- **Hallucinations**: AI models can generate false or inaccurate information in response to human prompts. For example, Air Canada was recently ordered to pay damages after its chatbot gave incorrect information about bereavement fares, leading to a customer's financial loss. ChatGPT was also involved in a legal case where a lawyer submitted fabricated court cases to support a legal brief;
- **Discrimination**: when an AI model makes connections between data based on algorithms, this may result in bias/ discrimination against individuals or groups;
- **Garbage in/garbage out**: when an AI system is trained on poor quality input data, the output will inevitably be of equivalently poor quality. It is inherently susceptible to human error at the data input stage and in all aspects of its subsequent use; and
- **Cyber crime**: AI is also susceptible to exploitation by malicious actors. It has been used to increase the sophistication of phishing attacks making phishing emails more believable by improving their wording and grammar. AI has also been used to generate 'deepfakes', audio or video content which mimics a genuine actor in order to extract personal and financial details.

These are just a selection of some emerging issues arising in the use of AI which highlight how things can go wrong, even where there is human involvement in the process.

*What types of liabilities can AI create for businesses?*

AI can give rise to a range of liabilities for businesses. In this section, we discuss the main types of claims by third parties that businesses may face arising from the use of AI:

- **IP Infringement**: central to almost any AI system is a large mass of data on which the system is trained. Although referred to as "data", the training materials are frequently themselves original works, in which copyright can subsist. The use of GenAI systems therefore has the potential to result in copyright infringement by users. There is a complex statutory regime governing copyright in Australia including defences of "*fair dealing*" for certain limited purposes, against which use of GenAI needs to be considered to understand infringement risk. Mis-use of confidential information through use of GenAI is also a relevant issue.

Emma Iles, an HSF partner specialising in intellectual property disputes observes: "*this is a new and complex area for Australian companies. While the potential risks of copyright infringement and mis-use of confidential information are real, there are a number of steps companies can take to to reduce risk, including ensuring contractual arrangements with AI service providers are negotiated with protections in place in case things go wrong, implementing policies and training directed to minimising key risks and using 'closed' system AI products (to protect confidential information).*"

- **Customer claims**: the use of AI in the provision of services (whether directly or even potentially in the background) has the potential to result in liabilities to customers or other third parties if they suffer loss or damage as a result. This could result in liability for negligence or contractual breaches if services are not provided with reasonable care or products that use AI technology do not comply with capabilities represented.
- **Discrimination**: the use of AI has the potential to result in unintended and unpredictable bias or profiling. Therefore, care needs to be taken when AI is used in facial recognition technology, the employment space or in determining eligibility for financial products such as mortgages.
- **Regulatory action**: regulators such as ASIC and the ACCC are increasingly focused on taking action to avoid harm resulting from AI. Whilst new codes and AI-specific legislation are under consideration, there are a number of existing laws relating to misleading and deceptive conduct and directors' duties that could be used by regulators to seek civil penalties for AI misconduct in appropriate cases. For example, 'AI washing' (ie where a company claims to possess a level of service relating to its use of AI which it does not in fact have) may be one of the new frontiers of regulatory action (like recent cases of greenwashing in climate disclosure cases).

  Christine Wong, a partner at HSF specialising in regulatory investigations and enforcement, observes that: "*statements about the use of AI can potentially be misleading in at least two ways: by falsely asserting capabilities that the relevant AI does not in fact have and/or by omitting to disclose key risks associated with the use of AI and how data about individuals is being used. Representations about AI can be complex, particularly where this is an area undergoing rapid technological advancement and there is currently a lack of standardised language and definitions concerning the use of AI.*"

  Tania Gray, an HSF partner specialising in regulatory disputes also notes: "*there are a multitude of existing causes of action that might apply to bad outcomes arising from the use of AI. Regulators will consider the range of tools in their arsenal to pursue action for conduct they consider worth pursuing.*"
- **Class Actions**: the Australian class action regime continues to be an avenue that plaintiff law firms and funders use to bring proceedings against both listed and unlisted companies involving allegations of loss to shareholders and consumers. To the extent a company is facing a regulatory investigation or suffers a substantial share price decline following the disclosure of adverse information to the market arising from an AI event, the possibility of a class action continues to loom large.

  Melissa Gladstone, a partner at HSF specialising in class actions observes "*class action risk remains a key issue in corporate Australia. The rise of AI, which is rapidly advancing ahead of the pace of regulation, presents yet another category of emerging risk for boards and directors to grapple with.*"

*First party losses*

Whilst third party liability risk presents some of the most obvious and significant potential liabilities facing companies that use AI, there are also a number of 'first party' issues that

can potentially occur causing loss to companies directly. For example:

- **System damage**: as AI becomes increasingly embedded in IT systems, it is possible that IT malfunctions or programming errors could result in system outages that cause system damage and business interruption loss. The recent CrowdStrike outage that caused global system failures is an example of the type of issue that can arise and also highlights the risks in relying on critical third party service providers. A logistics company which relies on AI to optimise its delivery routes and storage capacities could also suffer first party loss if the system does not perform.
- **Crime**: as noted above, threat actors are increasingly using AI to improve the sophistication of phishing scams and enhancing their ability to breach data security protections. The rise of AI arguably increases the risk of theft of company assets (both financial and data).
- **Physical damage**: given the extent of automation powered by AI already being used today, it is increasingly more likely that AI may cause physical damage. For example, by way of autonomous vehicles colliding with other property or even by way of an AI-powered thermostat malfunctioning and causing a fire in a factory.

## The role of insurance in mitigating AI risk

Insurance has a key role to play in helping companies mitigate financial impacts of the rising risk by spreading losses across the global insurance market. There are a number of policies, both traditional and emerging, that may respond to AI-related losses.

*Affirmative AI cover*

We are starting to see the early development of new, affirmative AI policies.

- Munich Re recently launched a product for users of AI, which is said to cover losses where an AI model doesn't deliver. So, if a bank replaced property valuers used for loan assessments with an AI model, and the AI makes a mistake that a human valuer would not have made, the policy may engage;
- a new start up insurer, Armilla Insurance, has launched a product providing a product warranty that AI models will work the way their sellers promise; and
- press reports in March 2024 announced that Coalition, a cyber insurer, has added an AI endorsement to their cyber insurance policies.

While currently nascent, the affirmative cover market is likely to expand, presenting opportunities for businesses that understand their risks and how these products might be suitable for them.

*Traditional policies and 'silent' AI cover*

Even where AI risks are not affirmatively covered, they may be 'silently' covered under traditional policy lines that do not exclude them.

Businesses should review their insurance arrangements to consider coverage for potential harm from AI use or misuse. Key policy lines to consider include:

- **Professional indemnity ("PI") insurance** will be relevant in the event of customer claims for services-related liabilities. Exposures may arise from AI related services or the use of AI in the provision of services or in the event of a regulatory action. Liabilities, defence costs, regulatory investigation costs and possible fines might be covered under PI policies.
- **D&O insurance** (Side A/B) may protect directors or officers facing regulatory action for a failure to manage AI risks appropriately. Separately, Side C (if purchased) may be relevant in the event of the company facing a securities' class action arising from the use (or alleged misuse) of AI.
- **Product liability insurance** may cover compensation and costs if a consumer suffers damage from a product powered by AI, such as a smart home device.
- **Cyber policies** may respond to security breaches or system failures and other privacy breaches relating to AI. They may also potentially respond to certain first party losses, including ransoms paid to malicious threat actors (a Crime Policy may also be relevant in the event of a ransom or conduct involving financial theft).
- **Employment Practices Liability insurance** may cover an employer for compensation claims for discrimination or unfair treatment resulting from AI systems.
- **Property Damage and Business Interruption** insurance will be relevant in the event that AI causes property damage and consequential business interruption.

Whether these policies may be engaged in the event of AI-related losses will of course depend on a number of factors. We foresee that the following issues may arise:

- **Blurred lines**: liability policies typically require a causal link between any claim against the company (or insured person) and the perils insured by the policy (eg acts/omissions in the performance of professional services in PI policies or wrongful acts by persons in their capacity as directors/officers in a D&O context). In this new frontier of autonomous AI decision making, it is possible that real questions may emerge as to which party has committed an act/error and whose conduct has given rise to the claim, and therefore which policy is the responsive one: are the acts attributable to humans or the AI itself? This may sound like science fiction, but policyholders should think carefully about how they are using AI and how any liabilities associated with AI translate to their policies.
- **AI exclusions**: whilst we have not seen specific AI exclusions appear in any traditional policy lines as yet, as these new risks develop, insurers will likely take a view on whether to price in or exclude AI risk. As we have already seen with cyber exclusions, policyholders should keep a close eye on AI exclusions being adopted in the market (either as standalone clauses or within existing cyber exclusions).

### Looking ahead

The future of AI presents significant opportunities and notable risks. On the opportunity side, AI has the potential to revolutionise industries by enhancing productivity, accelerating scientific research and improving decision-making processes.

However, these advancements come with risks. AI systems can breach copyright, discriminate against people and give rise to multifarious risks of harm to the public which government and regulators are becoming increasingly focused on.

As always, the role of human oversight and prudent risk mitigation remain front and centre in this new world of AI. The insurance market also has a critical role to play in this area and we will be watching closely to ensure corporate policyholders remain protected.

# Policyholders do have a LEG to stand on: Recent international decisions on LEG defect clauses

Historically, there has been only very limited judicial consideration of the London Engineering Group ("**LEG**") clauses commonly used to exclude costs relating to defects in Contract Works/Construction All Risks insurance policies. However, internationally there is now a growing body of case law in relation to the LEG defect clauses.

In 2023 and 2024 this has included favourable decisions for policyholders in the US in relation to the proper operation of the 'LEG3' clause. In particular, these decisions clarified that LEG3 does not exclude the cost of rectifying property to the state it was originally planned to be in, but rather is intended to exclude the cost of 'gold plating' replacement works on a construction project.

## What are the LEG Defect Clauses?

Contract Works policies are generally limited to covering physical loss or damage to tangible insured property on building and construction projects and exclude the cost of rectifying defects in such property themselves.

However, many claims face challenges in distinguishing what is an underlying (excluded) defect and what is the (insured) damage – particularly where the defect gives rise to the damage. There is therefore often controversy as to what costs are covered and what costs are excluded.

One of the most common ways of striking the balance between the costs arising from covered damage and excluded defects is by way of one of the three LEG defects clauses.

Those clauses describe what is excluded in different ways (emphasis added), although the drafting is somewhat unusual which has resulted in disputes as to the meaning and application of the exclusions:

| | |
|---|---|
| **LEG1 (most restrictive cover)** | **Loss or Damage** due to defects of material workmanship design plan or specification |
| **LEG2** | All **costs rendered necessary by defects of material workmanship design plan or specification** and should damage occur to any portion of the Insured Property containing any of the said defects the **cost of replacement or rectification which is hereby excluded is that cost which would have been incurred if replacement or rectification of the Insured Property had been put in hand immediately prior to the said damage**. |
| **LEG3 (often considered the widest cover, ie the narrowest exclusion)** | All **costs rendered necessary by defects of material workmanship design plan or specification** and should damage occur to any portion of the Insured Property containing any of the said defects **the cost of replacement or rectification which is hereby excluded is that cost incurred to improve the original material workmanship design plan or specification**. |

While LEG3 is often considered to be the widest cover, that is not universally the case in terms of the outcome in any particular claim (and in some policies, the policyholder has the ability to elect between LEG2 and LEG3). The effects of LEG2 and LEG3 are very fact dependent and require a detailed understanding of the defect, the damage and the rectification of both.

Historically, there has been limited case law discussing these clauses and any cases that had been decided were focused on LEG2. As a result, many claims have faced challenges in relation to what is actually excluded by LEG3 and, in particular, what is meant by the phrase 'incurred to improve'.

Arguments in relation to that clause often assert that the clause:

- **For Policyholders**: on a purposive reading, excludes only costs to make the design (etc) better than it was originally intended – such that the policyholder does not get something better than they were originally intending to construct; and
- **For insurers**: excludes any cost which results in the property being better than the defective state it was in prior to the damage.

The distinction is critical as insurers' interpretation can often result in there being no or little cover. However, recently US courts have had opportunity to consider the operation of the LEG3 clause, and have provided clarity as to its operation.

We summarise below the key decisions on both LEG2 and LEG3 clauses.

## LEG2 Variant: Rickard v Rickard [2004]

This Australian decision briefly considered the operation of a variant of a LEG2 clause. In this case the pavement in a depot collapsed within 3 days of it being put into service because rain had spread into the concrete during construction causing a build up of moisture and weakening the pavement. The slab had to be replaced.

The variant of the LEG2 clause excluded property which contained a defect, but wrote back cover for the costs caused by the defect less the cost of rectifying the defect immediately prior to the damage occurring.

Unfortunately for the policyholder, its claim failed:

- under the variant wording, the onus was on the insurer to prove that there was a defect in property, but (unusually) the policyholder then had to prove what costs were caused by the defect (which the court held they had not done); and
- rectifying the defect was not a matter of drying out the concrete, but of replacing the entire slab. Therefore, the cost excluded was the entire cost of replacing the slab (defeating the claim).

## LEG2: Acciona v Allianz [2015]

This Canadian decision related to the concrete slabs of a hospital. Defective formwork (ie defective workmanship) resulted in the as poured concrete cracking and not being flat.

The policy contained a LEG2 clause and the Court held that the cost excluded was not the cost of repouring the slab, but the cost that would have been incurred to implement appropriate workmanship had the defect in workmanship been identified early enough. No such costs were identified, so the claim was allowed.

In so deciding the Court articulated the reason underpinning these clauses: *Such costs, the costs of doing the job right, represent the moral hazard the Insurers intended to avoid by the Defects Exclusion.*

That is, the policy does not exist so that the insurers are to pay for the cost of doing the job right, it exists to indemnify the policyholder when something goes wrong and causes damage.

## LEG3: SCB v Lexington [2023]

This US case related to the cost of pouring concrete abutments on a bridge. The concrete was not vibrated sufficiently while poured and so the final product was honeycombed with voids, affecting the overall strength of the bridge.

The court rejected an argument by insurers that the honeycombed bridge had never been in a satisfactory state to start with, and so therefore there could not be said to have been 'damage'. Instead, the court considered that the honeycombing had a negative effect on the bridge and was damage.

The court rather emphatically described the LEG3 clause as '*ambiguous - egregiously so*' and held that it must therefore be read against the insurer. However, the court expressly considered what it meant to 'improve'.

In this respect, insurers argued that merely rectifying defective components was an 'improvement'. The Court held that while this had some intuitive appeal, the context of the clause instead suggests contrary to insurers' argument that "*to improve means to make a thing better than it would have been if it were not for defective work.*" It used the example of replacing the concrete with solid gold, as opposed to simply placing it in the state originally planned.

## LEG3: Archer Western – De Moya v Ace [2024]

This US decision related to concrete in a highway that had too much fly-ash in the mixture leaving it weaker than needed.

The case was an application for summary judgment which was denied on the basis that there were outstanding points of fact and therefore has limited precedential value. However, the case quoted favourably and extensively from the SCB decision in 2023, agreed that the term 'improve' in the LEG3 clause was ambiguous and ought to be interpreted against the insurer. The Court also rejected the insurer's arguments to distinguish the SCB decision.

## Lessons for Policyholders

Taken together, there is a growing body of international decisions considering the operation of the LEG2 and LEG 3 clauses. For the most part these decisions are helpful to policyholders in Australia (even if they are strictly only persuasive in Australian courts). The operation of the LEG defects clauses remain contentious in claims and is a matter that policyholders should be actively considering from an early stage.

## Some specific takeaways:

- Although some of these decisions are critical of the clauses themselves, care should be taken in deviating from the standard LEG wording. As the *Rickard* decision shows, subtle variations in the wording can have significant consequences;
- In applying the clauses, it is important to bear in mind their purpose – to strike the balance between not insuring the cost of doing the project properly in the first place, but providing cover for physical damage when something goes wrong; and
- International Courts have not looked favourably on adopting an overly literal interpretation of the word 'improve' in the context of the LEG3 clause – this term is not intended to exclude the cost of rectifying the property to its originally intended state.

*This article was written by Travis Gooding, Senior Associate (Australia), currently on secondment in our London team.*

# COVID BI case update

*COVID-related business interruption insurance cases continue to filter through the courts (albeit with less frequency than in previous years)*

By way of background, COVID BI test cases have in recent years provided helpful clarifications and developments in relation to novel questions of causation and the recovery of business interruption losses. We have written on a number of decisions in previous editions of Policyholder Highlights including the following two key Australian test cases:

- **First ICA Test Case**: *HDI Global Specialty SE v Wonkana No. 3 Pty Ltd* [2020] NSWCA 296 in which the NSW Court of Appeal found in favour of policyholders that exclusions for loss caused by diseases declared as quarantinable under the "*Quarantine Act 1908* (Cth) and subsequent amendments" did not exclude losses caused by COVID-19 (see our previous article on this case available here); and
- **Second ICA Test Case**: *LCA Marrickville Pty Limited v Swiss Re International SE* [2022] FCAFC 17 in which the Full Court of the Federal Court found that:
  - in 9 of 10 cases, insuring clauses that provided cover for BI loss in consequence of the closure or evacuation of insured premises as a result of orders made by certain public authorities did *not* provide cover for BI losses caused by COVID-19. The crucial finding for these policies was that the relevant State public health orders were not made as a result of an outbreak of COVID-19 within the specified radius of an insured premises, but rather were in response to the existence and risk of COVID-19 generally; and
  - in 1 of 10 cases, an insuring clause covering BI loss caused by the outbreak of a human infectious or contagious disease occurring within the 20km radius of a 'Situation' (ie an insured premises) potentially engaged coverage subject to further evidence. The difference in this wording was that it made no reference to the making of an order by a public authority. It was only necessary for the policyholder to establish BI loss by reason of a local COVID-19 outbreak within a specified radius, and not necessary to establish that the public health orders were made because of a local outbreak.

We provide an update on two recent 2024 decisions below. The *Princess Theatre* case is another example in which the Court has provided helpful guidance on a causation issue.

## Princess Theatre Pty Ltd & Ors v Ansvar Insurance Limited [2024] VSC 363

On 29 October 2024 we published an article summarising a recent judgment of the Supreme Court of Victoria (Osborne J) considering whether Melbournian theatre owners were covered for business interruption loss as a result of COVID-19 lockdowns in 2020 and 2021 under an infectious disease extension contained in two industrial special risk policies.

*The facts in brief*

The policyholder plaintiffs owned theatres in Melbourne and were insured under industrial special risk policies which contained infectious disease extensions.

The relevant extension provided:

- cover for business interruption loss in consequence of closure of premises 'by order of or in consultation with or upon advice from a Statutory or Government Authority **following** an outbreak of human infectious or contagious disease (that is notifiable)' [emphasis added]; and

- an exclusion of liability arising as a result of any diseases 'declared to be quarantinable diseases under the *Quarantine Act 1908* (Cth) and subsequent amendments'.

In 2020 and 2021, several lockdowns were declared in Melbourne to limit the spread of COVID-19. The policyholders sustained business interruption loss connected with the closure of theatres as a result of the lockdowns, and claimed over $20 million under the extension.

*Court's findings on coverage*

The Court found:

- the extension wording in this case differed from *LCA Marrickville* (a decision which found in favour of insurers) on the basis that the relevant clause in that case included the words 'as a result of' rather than 'following'. Favourably for policyholders, the Court found that the 'following' element of the extension required the insured to be able to establish that an outbreak occurred within the relevant radius, that an order was subsequently made, and that there was a connection between the two. It did not require the insured to establish that the outbreak was the sole or even the dominant cause of the making of the order, only that the two were connected and that an outbreak occurred prior to any order relied upon;
- the statement from the Prime Minister that non-essential businesses should not open in circumstances where more than 500 people may be present met the policy requirement that the closure was made 'upon advice from a [relevant] authority' and, in any event, shortly thereafter a formal closure order was made which separately triggered cover; and
- consistent with the NSW Court of Appeal's decision in *HDI Global Specialty SE v Wonkana No. 3 Pty Ltd* [2020] NSWCA 296, the *Biosecurity Act* (under which COVID-19 was a listed human disease) was not a "*subsequent amendment*" to the *Quarantine Act* (under which COVID-19 was not listed as a disease and which had been repealed) and the Court found that insurers had not demonstrated that the policy should be rectified on equitable grounds to give effect to an alleged common intention to the contrary. The effect of this finding was that the exclusion did not apply to the policyholders' COVID-related losses.

## Takeaway

The decision shows that the term 'following' in an insuring clause may impose a looser causal requirement than 'as a result of', particularly where the purpose of the term is uncertain from the terms of the policy. Indeed, the requirement that one event occur 'following' another may require only that the former occur later in time than, rather than having been caused by, the latter.

## Cody Gemtec Retail Pty Ltd v Underwriting Members of Syndicate 2003 at Lloyd's (Declassing Applications) [2024] FCA 1098

On 20 September 2024, the Federal Court (Lee J) delivered judgment in favour of insurers seeking to 'declass' (and effectively end) proposed class actions brought by policyholders with causes of action relating to two earlier Test Cases determined by the NSW Court of Appeal and Full Federal Court.

*The issues in brief*

We have written about the Test Cases in previous editions of Policyholder Highlights as well as standalone articles which can be accessed here and here. The policyholders in these class actions brought their claims on the basis that despite the Test Cases, substantial common issues of law and fact remained which were amenable to be determined by way of a class action.

*The Court's decision*

Justice Lee agreed with insurers that the proceedings should be declassed finding that:

- the asserted common issues of law and fact were not "*substantial*" as required to commence a class action under s 33C of the *Federal Court Act 1976* (Cth). The issues were substantially addressed by the Test Cases and the limited issues that remained were either not subject to any real controversy or were fact dependent in each policyholder's claim; and
- the consequence of the above was that the class action ought not continue by reason of the fact that the proceedings would not provide an efficient and effective means of dealing with the claims of group members as provided for in s 33N of the *Federal Court Act 1976* (Cth).

Justice Lee noted that a private claim process was well advanced between policyholders and insurers and that this process was expected to be completed earlier than if the Court was to put in place a reference process after an initial trial of the class action proceedings.

Justice Lee took a dim view of insurers' choice to run the original proceedings by way of test cases instead of utilising the class action regime, which he argued would have allowed any findings in litigation to become legally binding upon all potentially affected insureds (and allowing individual claims to be resolved pursuant to a Court supervised process). His Honour also observed that the duplication of litigation arising by way of the declassing applications suggested the decision to adopt a test case regime (although providing *some* of the same benefits achievable by use of the class action procedure), did not constitute the *optimal* way of facilitating the just resolution of the disputes between the insurers and insureds according to law, and as quickly, inexpensively and efficiently as possible.

Justice Lee ordered the parties to confer regarding arrangements for notifying group members of the outcome of the proceedings prior to making final declassing orders.

## Takeaway

Policyholders who would have been included within this class action will now need to progress their claims with insurers individually. If a policyholder is unsatisfied with the outcome of their claim, they retain the right to litigate their claim against insurers individually through the courts.

*This decision is currently under appeal*

# D&O risk and insurance update

## Director risk update

The underlying risk environment for Australian directors remains relatively unchanged over the last 12 months, with regulators continuing to investigate and prosecute cases in line with existing enforcement priorities. Consistent with recent trends, there has been an uptick in regulatory focus on misconduct relating to reporting on environmental sustainability (and ESG generally) and a continued emphasis on technological and operational resilience (including cyber resilience) for market operators and market participants, including in relation to the use of Artificial Intelligence (**AI**).

Some recent examples of interest:

- ASIC made 47 regulatory interventions to address greenwashing misconduct during the 15 month-period ending 30 June 2024;
- in May 2024, ASIC Commissioner Alan Kirkland delivered a speech at the Australian Finance Industry Association Risk Summit noting that "*AI opens up entirely new vectors of potential harm to consumers, and to market integrity*". Mr Kirkland also outlined the legislative bases on which ASIC could take action for the misuse of AI, including misleading representations or inappropriate product distribution facilitated by AI and the use of AI in breach of general licensing obligations or directors' or officers' duties in the Corporations Act;
- in September 2024, ASIC Chair Joe Longo reinforced ASIC's focus on cyber resilience in a speech delivered at the AFR Cyber Summit noting that "*if things go wrong, ASIC will be looking for the right case where company directors and boards failed to take reasonable steps, or make reasonable investments proportionate to the risks that their business poses*"; and
- directors and companies will also need to take care making forward-looking statements relating to climate under the incoming mandatory climate-related financial disclosures regime, which will have a phased implementation starting from January 2025. Commenting on ASIC's approach to enforcement for this new regime, ASIC Commissioner Kate O'Rourke noted in an August 2024 speech that ASIC's initial approach to enforcement will be "*pragmatic and proportionate*", with enforcement action to be reserved for "*really egregious breaches*".

## Class action risk update

The last 12-18 months has been a fertile time for class action judgments with the Federal Court dismissing three proceedings against CBA (*Zonia Holdings v CBA* [2024] FCA 477), Insignia (*McFarlane v Insignia* [2023] FCA 1628 and WorleyParsons (*Crowley v Worley (No 2)* [2023] FCA 1613). The position to date remains that no shareholder plaintiff has successfully prosecuted a class action claim to judgment in Australia.

However, further judgments are expected in the next 12 months and a number of recent judgments are currently under appeal (in particular cases involving CBA and Worley Parsons which concern important questions of materiality and attribution of knowledge).

In another notable development, in February 2024 Dr. Kevin Lewis (former chief compliance officer for the ASX

responsible for Guidance Note 8 relating to continuous disclosure) issued his independent review of the amendments to the continuous disclosure laws made in 2021 which introduced a requirement for a breach of continuous disclosure laws that the disclosing entity acted knowingly, recklessly or negligently.

The review recommended that the "*knowingly, recklessly or negligently*" requirement be:

- removed for ASIC in civil penalty proceedings as it has had a negative impact on enforcement of continuous disclosure laws by ASIC; and
- retained for private litigants in civil compensation proceedings (eg class actions), on the basis that the amendments have had, and are likely to continue to have, little (if any) impact on the number and type of continuous disclosure class actions against disclosing entities.

The Commonwealth Government has accepted these recommendations in principle, although amending legislation will need to be brought forward for any changes to come into effect.

## D&O market update

Consistent with a general softening in D&O market conditions over recent years (as reported in previous editions of Policyholder Insurance Highlights), we understand from market reports there continue to be opportunities for further premium reductions in the D&O insurance market as well as opportunities for reduced deductibles (albeit with premium consequences). In light of these reported reductions, we understand some companies are now seeking to reinstate Side C coverage or increase limits (and/or reduce deductibles) to take advantage of more favourable market conditions.

We are also aware of some insurers offering new D&O products, including defence costs products which include reimbursement of preferred lawyers' costs at full market rates.

Continued premium reductions do not appear to be a function of an actual or perceived reduction in shareholder class action or director risk, but rather insurance market dynamics as new entrants to the market continue to compete for market share. D&O insurers may also be somewhat buoyed by a number of favourable judgments for defendants in shareholder class actions to date.

We set out below some other notable legal developments over the past 12 months which may be of interest to observers of the Australian D&O insurance market.

## Notable legal developments

*CIMIC appeal*

In a long awaited judgment, the NSW Court of Appeal (White JA, Stern JA and Griffiths AJA) affirmed an earlier decision of the NSW Supreme Court which found that Leighton Holdings Limited (now CIMIC) breached its duty of disclosure in relation to a tender for an infrastructure project in Iraq and, accordingly, D&O insurers were entitled to reduce their liability to nil.

Our team has previously written on the implications of the primary judgment (see here).

In summary:

- the case primarily turned on whether CIMIC ought to have disclosed to insurers information contained in a file note prepared by a senior officer of Leighton prior to inception of the policy. The file note suggested the company had won a tender in Iraq by way of an unlawful payment and that there was an opportunity to win another tender by a similar unlawful payment;
- the Court of Appeal held that a reasonable person in the insured's circumstances would have known, and not merely 'strongly suspected or believed', that the serious allegations set out in the file note regarding the alleged payment of bribes would be relevant to the insurers' decision to accept the risk and that insurers were entitled to reduce their liability to nil on the basis that they would have inserted a bribery exclusion or similar had the relevant matters been adequately disclosed prior to inception of the policy; and
- the Court of Appeal further found, contrary to the primary judge, that there *was* sufficient evidence that the representations in the file note were true, that Leighton knew the payments may have been unlawful and that these facts should have been disclosed to insurers.

The decision shows that an insured must closely consider its disclosure obligations, including (as far as possible) from the perspective of a reasonable person in its circumstances, including consideration of particular types of operational risks which are sufficiently unusual or serious to warrant specific disclosure. Close consideration should be given to disclosing any circumstances which suggest impropriety or unlawfulness.

*Carter v Chubb Insurance Australia Ltd [2024] FCA 1312 – fraudulent non-disclosure and repayment of defence costs previously advanced under policy*

In another case concerning a senior company officer's knowledge of unlawful payments, the Federal Court (Halley J) found that the CEO of Orix (Mr Carter) either knew or was recklessly indifferent to the existence of certain material facts regarding unlawful payments/inducements at the time of signing a D&O proposal form and his failure to disclose those facts to insurers constituted fraudulent non-disclosure resulting in an order to repay defence costs previously advanced by insurers.

The facts in brief were that:

- Mr Carter, the CEO of Orix (a motor vehicle finance company that, among other things, leased vehicles to small and large businesses), made a claim under Orix's directors and officers liability policy (**the Policy**) in respect of costs incurred to defend criminal and civil proceedings arising from certain unlawful payments and inducements made to procurement managers of the company's customers;
- in mid-2015, Chubb initially accepted that defence costs were payable in relation to the claim and advanced $657,277.38 (excluding GST) to Mr Carter, subject to reserving its rights under the Policy as further information came to light; and
- in April 2017, following its review of the material served by NSW Police in the criminal proceedings, Chubb notified Mr Carter that it believed he had engaged in, and was aware of, fraudulent non-disclosure by Orix at the time the Policy was entered into. Chubb suspended the payment of defence costs and sought repayment of sums previously advanced.

Chubb claimed that at the time Mr Carter signed the D&O proposal form, he (a) knew the relevant facts regarding the relevant customer transactions, (b) did not disclose the information he knew, (c) declared that the information in the proposal was true and correct in every detail, and (d) caused Orix to make fraudulent representations and engage in fraudulent non-disclosure.

Mr Carter claimed that he did not have knowledge of any relevant facts as the payments were made by other employees of Orix and there was no reason to doubt the apparent authority of the relevant customer procurement managers who instructed those employees to make those payments.

In summary, the Court found:

- Mr Carter's denials of his knowledge of the payment of bribes and provision of illegal inducements were implausible given the extent of his involvement in the impugned transactions as demonstrated by the contemporaneous documents and the inherent logic of events. The Court noted there was little, if any, ambiguity in the emails passing between Mr Carter and certain key employees. On no plausible view was Mr Carter a peripheral observer who did not have any real or substantive appreciation of the payment of bribes and provision of illegal inducements. Further, it can readily be inferred from the nature of the payments made that they had not been properly authorised by the relevant counterparties;
- Mr Carter was found to have signed the proposal form without giving any real consideration to its contents and was found to have been recklessly indifferent to as to whether the information contained in the proposal and in documents accompanying it were true and correct in every detail and that no other material facts had been misstated, suppressed or omitted; and
- Mr Carter was further found to have knowledge of the relevant customer transactions pleaded by insurers as being material to their underwriting of the risk and that at the time he answered questions on the proposal form he knew that they may give rise to a claim that may be covered under the Policy or was recklessly indifferent to those matters.

The Policy contained a clause waiving Chubb's right to avoid the Policy in circumstances of fraudulent non-disclosure or misrepresentation, instead limiting Chubb's remedy to declining indemnity under the Policy and returning it to the position it would have been in had the fraudulent non-disclosure not occurred under s 28(3) of the *Insurance Contracts Act 1984* (Cth). The Policy also contained a fraud exclusion, but given the Judge's conclusions above, it was not necessary to decide on it.

The Court found that Chubb was entitled to decline Mr Carter's claims for indemnity under the Policy and was entitled to repayment of defence costs previously advanced.

While obviously an outlier on its facts, the decision is a timely reminder that persons responsible for completing proposal forms prior to inception (including on renewal) should take that responsibility seriously, make all reasonable enquiries to identify potential claims or circumstances that may require disclosure and disclose all material facts to insurers prior to policy inception (obtaining legal advice as necessary).

*Bentley Capital v Keybridge Capital – court orders two companies to contribute to mutual director's legal costs where each company indemnified director under separate indemnity deeds*

In a novel first instance decision in the Federal Court (Banks-Smith J), the Court considered whether and to what extent a mutual director of two companies was entitled to be indemnified by each for legal costs the director had incurred in proceedings involving both companies.

The issue arose against the backdrop of proceedings between two shareholders concerning the validity of director nominations to Keybridge Capital Limited (**Keybridge**). The proceedings concerned competing claims between Bentley Capital (**Bentley**) (and its preferred director Mr Johnson) and Australian Style Group (**ASG**) (and its preferred directors Mr Patton and Mr Kriewaldt).

Mr Johnson and Mr Patton were both existing directors of Keybridge and held indemnity deeds with it that covered costs they incurred in connection with legal proceedings involving the company. Mr Johnson was also a director of Bentley which entered an identical indemnity deed with him in respect of legal proceedings involving Bentley. Importantly, both company's indemnity deeds indemnified the directors only "*to the extent that the Director is not otherwise indemnified*".

Mr Patton was indemnified by Keybridge for his costs of the proceedings. However, Mr Johnson was not indemnified by Keybridge on the basis that Mr Johnson was "*otherwise indemnified*" through his indemnity arrangements with Bentley. Keybridge also cited Mr Johnson's purported entitlement to indemnity under D&O policies held by Bentley and Keybridge and the fact that Bentley had already made certain 'advance payments' to Mr Johnson which had the effect of otherwise indemnifying him.

In summary, the Court found:

- the 'advance payments' made by Bentley to Mr Johnson were not characterised as indemnity payments under its deed as they were provisional in nature and were intended to be repaid;
- the D&O policies held by Keybridge and Bentley were similarly unlikely to indemnify Mr Johnson for the costs he had incurred in legal proceedings to date, principally because Mr Johnson and Bentley had commenced those proceedings (such that there was no 'Claim' against Mr Johnson) and Mr Patton's counter-claim sought declarations of invalidity of certain company resolutions rather than asserting any 'Wrongful Act' against Mr Johnson; and
- in these circumstances, Bentley and Keybridge were each under a co-ordinate liability to indemnify Mr Johnson meaning both indemnity deeds responded to his losses. Ultimately, the Court ordered that Bentley indemnify Mr Johnson in the first instance with Keybridge to contribute equally to those indemnified sums by way of equitable contribution.

This case involved relatively novel facts, but is a good illustration of the approach a court is likely to take in the event there is a dispute between multiple companies each liable to indemnify a common director. The Court placed significant weight on the materially identical terms of the indemnity deeds in this case and applied principles of equitable compensation to arrive at a fair split between coordinate liabilities. The case is a useful reminder to describe the basis for any payments made to directors accurately, particularly where they are intended to be advances/loans rather than indemnities.

*APFC No 1 v Insurance Australia Limited – ATE insurance and security for costs*

Finally, in a decision of interest for litigators (including class action practitioners), the NSW Supreme Court (Nixon J) held that a plaintiff's after-the-event insurance policy (**ATE policy**) was insufficient to provide security for costs to a defendant on the facts of this case. ATE policies are frequently proffered by plaintiffs in shareholder class actions to avoid the need for a cash payment or bank guarantee to satisfy the requirement for security for costs.

By way of reminder, ATE insurance is a policy that typically covers a party's liability to pay an adverse costs order and its own disbursements in the event it is unsuccessful in litigation. It is a common form of security in shareholder class actions, often used in conjunction with other forms of security (such as a payment into court, bank guarantee or deed of indemnity).

In this case, Nixon J held that:

- the Court has broad discretion as to the form of security for costs. The question is whether the security put forward is 'adequate to achieve the object of providing a fund or asset against which a successful defendant can readily enforce an order for costs'.
- whether an ATE policy is adequate to achieve that object is assessed by reference to the meaning and effect of the terms of the policy and the extent to which there is a risk that the insurer, acting in good faith but in its own commercial interests, could seek, on legitimately contestable grounds, to avoid, limit or reduce its liability under the policy leaving a defendant without any protection in respect of a costs order made in its favour.
- the ATE policy in this case was not one that provided adequate security. This was due to, among other things, coverage being limited to "*fully mitigated*" adverse costs (ie potentially less than what was payable to a defendant) and the indemnity being triggered only once proceedings were "*finally concluded*" (ie arguably once all appeals were concluded which could potentially leave a defendant without an enforceable asset for several years).

While this decision turned on its own facts and the terms of the ATE policy in issue, it confirms that Courts have broad discretion in matters concerning security for costs. It illustrates the importance of being satisfied with the adequacy of any security proffered by a party seeking to prosecute a claim and being comfortable that the security is not unduly conditional. The decision highlights that particular care should be exercised where an ATE policy is the only security proffered in the absence of other forms of security such as a bank guarantee or deed of indemnity.

# Absolute win for policyholder in PI claim for defective design

*Absolute Tiling Solutions Pty Ltd v Certain Underwriters at Lloyds* [2024] NSWSC 364

## Facts

Absolute Tiling was subcontracted by a construction company to design and construct floor and wall tiling systems at a property. The original design specifications provided for the property to be clad in sandstone tiles fixed to the external walls by pins. Later, the parties agreed the tiles were to be glued on to the external walls to significantly reduce the costs, and Absolute Tiling went ahead with installing the tiles by this method.

From around the time of the building's completion, the tiles began to detach from the property. The construction company claimed against Absolute Tiling. Absolute Tiling made a claim under its professional indemnity policy (**the Policy**).

## Decision

The decision covers a broad range of issues. This summary focuses on the non-disclosure aspects of the decision and a related 'known circumstances' exclusion.

*Was the loss proximately caused by installation or design activities?*

The insurers initially contested their liability under the Policy on the basis that Absolute Tiling did not have a "*Claim*" "*resulting from the conduct of the Insured Activities*", which was necessary for coverage. The insuring clause contained a carve-out in respect of the "*performance … of … installation*" of the tiles, which the insurers claimed applied. That issue was ultimately not pressed in the insurers' closing oral submissions, but the Court considered it nonetheless to frame its approach to the other issues of policy construction.

The NSW Supreme Court (Nixon J) considered that the requisite causal connection between the loss and the "*Insured Activities*" under the Policy was the standard of "*proximate cause*", which is the presumptive test in the absence of a contrary intention in the policy.

On the evidence, the parties' experts agreed that most of the sandstone tiles had detached because they had failed to bond to the waterproofing layer of the exterior wall. The experts also agreed that the initial design – pinning the tiles to the wall – would have eliminated this risk of detachment, and they did not dispute that the system of gluing the tiles to the walls was not suited to the property due to the waterproofing layer.

In short, the subsequent detachment was inherent in the design choice to use glue rather than pins. While there were some deficiencies in the installation of the tiles – either not enough or too much glue had been applied on some tiles – these instances did not materially contribute to the overall loss. It followed that the proximate cause of the detachment of the tiles was the use of the tile adhesive system, which was a design flaw rather than a flaw arising from Absolute Tiling's performance in installing the tiles.

*Non-disclosure of known circumstances*

Insurers also resisted accepting liability under the Policy on the basis, amongst others, that Absolute Tiling had failed to disclose circumstances or claims that were known prior to entry into the Policy which might give rise to a claim.

The insurers alleged that before the relevant date Absolute Tiling was aware that the tiles were detaching, and that the construction company could blame Absolute Tiling for this issue. This argument was put in two ways: first, under an exclusion clause in the Policy and, secondly, under the duty of disclosure in s 21 of the *Insurance Contracts Act 1984* (**ICA**).

In relation to the exclusion clause, Nixon J found that, on the authorities, insurers were effectively required to prove Absolute Tiling had *actual knowledge* of the failure of the tiles to bond to the waterproofing membrane of the exterior wall, which was a design deficiency. Nixon J found that Absolute Tiling's knowledge regarding the detachment of the tiles at the relevant time was in fact "*relatively limited*". While it was aware of some tiles detaching, "*no issue had been raised regarding Absolute Tiling's design or installation of the tiling system*". The exclusion clause therefore did not apply to deny cover.

In relation to the statutory duty of disclosure, insurers alleged that Absolute Tiling ought to have disclosed to insurers the existence and extent of the detachment of the tiles in December 2019, prior to Absolute Tiling's entry into the Policy in late January 2020.

The Court found that this argument unpersuasive because, assuming the alleged contravention of s 21 was established, the insurers' remedy would have been to have their liability reduced to the amount that would place them in the same position they would have been if the non-disclosure had not occurred: s 28(3) of the ICA.

Nixon J accepted the evidence that, had disclosure been made in around December 2019, Absolute Tiling would have claimed under the previous year's policy. Since the terms of the previous year's policy and those of the Policy were materially the same, the insurers would have been in the same position under either policy.

Nixon J further found that since Absolute Tiling had limited knowledge of the detachments of the tiles, it had not breached the duty of disclosure under s 21 of the ICA.

*Disclosure of the nature of the business*

Insurers also alleged that Absolute Tiling had breached its duty of disclosure under s 21 of the ICA by failing to disclose that the nature of its business activities would include undertaking external cladding work, rather than only internal "fit out" works. Nixon J found that Absolute Tiling's work in external cladding was not specifically disclosed to insurers.

The question of whether Absolute Tiling had breached its duty of disclosure under s 21 of the ICA first depended on whether a reasonable person in Absolute Tiling's position could be expected to know that undertaking external cladding work would be a matter relevant to the insurers' acceptance of the risk.

In answering this question Nixon J reasoned that the lack of any inquiry by the insurers as to whether Absolute Tiling would be performing external cladding works was relevant. The fact that "*not a single question*" about external cladding works was asked of Absolute Tiling in the insurance proposal forms or correspondence was a powerful factor telling against the conclusion that a reasonable insured would understand that external cladding works in some way affected the insurers' decision to accept the risks on the Policy.

In any event, Nixon J was not satisfied that, had Absolute Tiling disclosed the fact that its works extended to the design or installation of external tiling, the insurer would have decided to refuse cover. Nixon J based this conclusion both on his observation that none of the insurers' underwriting guidance for excluding risks for particular forms of work referred to external cladding, and, again, no questions were asked by the insurers about external cladding at the inception of the Policy.

## Lessons for Policyholders

This decision is a useful case study of the application of the principles concerning proximate cause and pre-contractual disclosure. It highlights the decisive role that expert evidence often plays in determining proximate cause in factually complex cases. It also emphasises the central importance of underwriting evidence in non-disclosure cases and the burden on insurers to adduce that evidence in support of any non-disclosure allegations.

# Hull of a problem: what is property damage?

*Capral Limited v Insurance Australia Limited t/as CGU Insurance* [2024] FCA 775

## Facts

Capral Limited (**Capral**) manufactured and supplied aluminium products for use in, amongst other things, marine vessels and imported baches of rolled aluminium plate (**Plate**) for sale in the Australian market.

In late 2020, it was discovered that Plate sold in the period June to October 2020 was non-compliant with certain independent testing standards for corrosion resistance and had not undergone requisite heat treatments. While vessels incorporating the Plate could still technically have been used in the short-term, their useful life was severely impacted because the Plate did not possess the requisite corrosion resistance qualities. Each customer elected to remove the Plate and/or reconstruct the Vessels using compliant material.

Ten customers brought proceedings against Capral in respect of the defective Plate. Capral entered settlement deeds with each customer on similar terms with each deed variously referring to settlements being in relation to claims for "*property damage*" among other things.

Capral sought indemnity under a General Products and Liability Policy (**the Policy**) issued by CGU Insurance (**CGU**) in respect of the customer settlements. In the first instance, the Court was asked to determine two initial issues of policy construction by way of separate questions:

- first, whether the settlement sums were in respect of claims "*for Property Damage*" within the meaning of the insuring clause of the Policy; and
- secondly, whether Capral's claim was excluded on the basis the customers' claims involved liabilities resulting from failure to meet contractual performance standards (cl. 6.11) and/or costs relating to withdrawal of products due to known or suspected defects (cl. 6.14.2)

## Decision

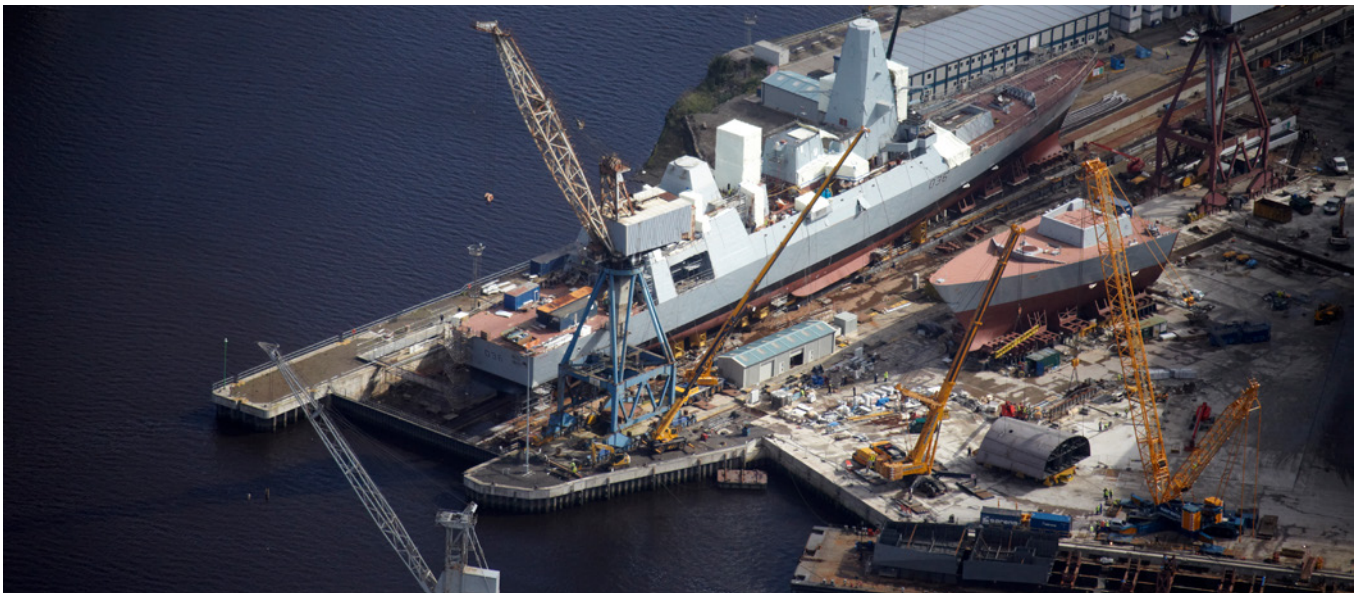
In summary, the Court (Jackman J) found that (1) the amounts paid by Capral pursuant to the deeds of settlement were in respect of a claim '*for Property Damage*' within the meaning of the Policy; and (2) Capral's claim was not excluded under certain policy exclusions.

*The first issue – claim "for Property Damage"*

The Policy relevantly covered all sums which the Insured was legally liable to pay to a third party in respect of compensation "*for Property Damage*" with Property Damage being defined as "*physical injury or damage to or physical loss of or destruction of tangible property including loss of use at any time resulting therefrom.*"

The dispute between the parties was whether the customer's claims were "*for Property Damage*" or whether the claims merely related to goods that were not fit for their intended purpose which resulted in them being outside the scope of the insuring clause and/or excluded by the Policy.

After an extensive review of the authorities in Australia, Canada, the US and the UK on the meaning of the term "*Property Damage*" particularly in cases where defective products have been incorporated into larger tangible property, Justice Jackman determined that one must ask two critical questions: (1) has there been a physical alteration of the tangible property; and (2) has that physical alteration impaired the usefulness or value of the tangible property.



In applying this two-stage test, Justice Jackman J found:

- there had been a physical alteration of tangible property (the customers' vessels) by welding the defective Plate to the hulls (it was observed that merely placing material on or inside a structure without affixing it is unlikely to constitute physical alteration); and
- that physical alteration impaired the usefulness or value of the tangible property (the customers' vessels) as the vessels could not proceed to market without the Plate being removed, and the cost of such removal was substantial. This made the vessels less useful and less valuable immediately after affixing the Plate than immediately beforehand.

Justice Jackman found that the customers' claims were 'for' Property Damage insofar as each of settlement deeds was in respect of the cost of reinstating the vessels to their state immediately prior to the welding of the Plate. To the extent the settlement deeds included other unrelated heads of loss, those would need to be deducted from any indemnity payment at a later date.

*The second issue – the applicability of exclusion clauses*

After finding the Policy did respond to the customers' claims on the grounds they were "*for Property Damage*", Justice Jackman turned to two exclusions pressed by CGU.

The first exclusion (cl. 6.11) excluded liability for loss of use resulting from a failure of a product to meet contractual performance standards or failure of the insured to perform a contract, but only in circumstances where the relevant property had not been physically damaged. As His Honour had already determined the vessels were physically damaged, this exclusion did not apply.

The second exclusion (cl. 6.14.2) excluded liability for any costs or damages claimed in relation to the withdrawal, recall, inspection, repair, replacement, or loss of use of products, or any property of which such products form a part, because of known or suspected defects.

Justice Jackman found that the second exclusion was a "sister product" exclusion directed at circumstances where a product is found to be defective and other identical products need to be withdrawn or recalled for inspection. The relevant loss of use to which the second exclusion applies is the loss of use occurring *after* the product is withdrawn or recalled. In this case, as Capral's customers suffered Property Damage upon the incorporation of the Plate into their vessels *prior to* discovering the Plate was defective and the products being recalled, the exclusion did not apply.

## Lessons for Policyholders

This is an important decision that sets out a useful survey of the international authorities and principles applicable to the meaning of "*property damage*" which is a common policy trigger in a number of different policy types, including public liability and industrial special risks policies. The decision confirms that the words "loss of use" when used in definitions of physical damage results in a significant broadening of the concept of damage beyond mere physical damage to tangible property by also capturing property that is rendered less useful or valuable. The two stage test for physical damage set out in this decision is a useful reference for policyholders with similar claims.

*This decision is currently under appeal.*

# Stacked against the odds: cover confirmed for damage occurring after policy period

*Baralaba Coal Company Pty Ltd v AAI Ltd trading as Vero Insurance* [2024] FCA 532

## Facts

Baralaba Coal Company Pty Ltd and Wonbindi Coal Pty Ltd (**Baralaba**) were joint venture partners in a coal mine at Baralaba in Central Queensland. Baralaba was insured under an industrial special risks policy for the period 1 May 2018 to 30 April 2019 (**the Policy**).

In March 2019, a radial coal stacker at the mine was damaged during a storm. Insurers granted indemnity for the damage under the Policy and repairs were commenced by the insured.

Following the expiry of the Policy but prior to the completion of repairs, the stacker suffered additional damage when it collapsed on 27 October 2019. This occurred during the final testing and commissioning phase of the repair works.

Baralaba claimed that Insurers were required to fulfil their obligation under the Policy to pay for the reinstatement of the stacker so that it achieved its pre-damaged state, which was said to include remediating the intervening damage resulting from the collapse. Insurers denied any obligation to do so, asserting that their obligation extended to meeting only the cost of repairing the damage caused by the initial storm incident.

Insurers also sought to decline the subsequent damage claim by reference to (a) certain policy exclusions that excluded cover for property that was "*subject to contract works*" and property damaged during testing and commissioning; and (b) a release executed by Baralaba in June 2020 in respect of its claim made in relation to the initial storm damage which Insurers contended also released any claim in relation to the later damage.

## Decision

The Court (Derrington J) rejected Insurers' arguments and found in favour of Baralaba.

*Coverage for subsequent damage outside policy period*

The Court found that Insurers' obligation to indemnify Baralaba pursuant to the Basis of Settlement clause in the Policy crystallised upon the occurrence of damage to the radial stacker during the first storm and, from that point onwards, Insurers were under a continuing obligation to pay for the cost of the reinstatement or repair of the damage so as to restore the stacker to a condition substantially the same as its condition when new.

After undertaking a survey of the case authorities, Derrington J concluded that the principle those authorities stand for is that an insurer's primary obligation to meet the costs of reinstatement necessarily extends to the cost of remediating any further damage to the property which is "*relevantly connected*" to that primary obligation. In this regard:

- it is not to the point that the further damage sustained to the stacker occurred following the conclusion of the period of Policy cover. The Insurers' obligation to meet the cost of reinstatement attached during the relevant period, and it does not matter that the obligation became more onerous after the end of the period of cover. The stacker's collapse in this case had a relevant connection to the repair of the original damage; and
- nor was it to the point that, if the repairs to the stacker had been complete in September 2019 and the subsequent damage occurred in October 2019, a reasonable businessperson would not have thought that the latter damage was covered. That was not the position here where the stacker had not yet been put

back into its pre-damaged state prior to the second incident and Insurers' obligation had not yet been completed.

The Court emphasised that the test is one of relevant connection between the insurer's obligation to indemnify and the subsequent damage. By contrast, the Court noted that cover would not extend where the only connection between an insurer's obligation to indemnify and the additional damage is that the additional damage occurred during the process of reinstatement (eg where, whilst insured property is being repaired, it sustains additional damage from an unrelated event such as fire).

*No exclusions applicable*

The Court held that none of the exclusions applied:

- in relation to the "*contract works*" exclusion (which had an associated requirement that contract works were excess of $1m), the Court found that it would be an unbusinesslike construction if this exclusion operated to defeat Insurers' obligation to meet the costs of repairing property, if damage occurred during the course of the very repairs in respect of which indemnity has been granted. The fact that the repairs may have been the subject of contract works was irrelevant in the current circumstances; and
- in relation to the "*testing and commissioning*" exclusion, the Court found that the text and context of the Policy supported a construction that this exclusion was limited to newly constructed plant/equipment and not the repair of existing equipment forming part of Insurers' obligation to pay for the cost of the reinstatement or repair.

*Scope of the alleged release*

Finally, the Court was not persuaded that the release signed by Baralaba in June 2020 was intended to release Insurers from all liability relating to the storm damage, which Insurers said included damage arising from the subsequent collapse of the stacker in October 2019.

Whilst the words "*arising from storm damage*" in the release were broad, the Court found the objective intention of the parties having regard to the surrounding circumstance was that it did not prevent Baralaba claiming in respect of the subsequent collapse. This was clear from emails exchanged between the parties at the time of signing the release. The Court noted that any suggestion to the contrary by Insurers was "*somewhat opportunistic*".

## Lessons for Policyholders

This decision shows that, once an insurer's obligation to indemnify has been enlivened under a policy covering damage to insured property, subsequent damage occurring after the expiry of the policy period may still be covered depending on the circumstances. Where loss/damage is sustained after the expiration of the policy, policyholders should consider the extent to which further loss/damage continues to be relevantly connected to the original loss such that it remains within the scope of the insurer's ongoing indemnity obligation. The terms of the policy are paramount in this regard and coverage depends on the wording applicable to each claim.

The issue of insurability of damage occurring after the policy period has also been topical in the English courts. In this respect, see our London team's article on *Sky UK Limited & Another v Riverstone Managing Agency Limited & Others* [2024] EWCA Civ 1567 in which they recently acted for the successful policyholder.

# The principal and the class (definition)

*Hansen Yuncken Pty Ltd v The Hollard Insurance Company Pty Ltd* [2024] FCA 398

## Facts

Hansen Yuncken Pty Ltd (**HY**) was the principal contractor responsible for refurbishing certain commercial premises in Hobart, Tasmania (**the Site**).

HY subcontracted the work of supplying and installing floor coverings on the Site to Choices Flooring, which further subcontracted part of its work to Mr Peter McConnon.

Mr McConnon sustained personal injuries while climbing over a retaining wall at the Site and commenced proceedings against HY alleging that his injuries were caused by HY's employees directing him to enter the Site in an unsafe manner.

The Policy covered two relevant categories of insured persons:

(a) persons named on the Insurance Certificate, which included Choices Flooring as named Insured and '*all parties for whom the Insured undertakes to insure for their respective rights, interests and liabilities*' (**Undertaking Category**); and

(b) every principal of the Insured, but only "*in respect of that principal's liability caused by the performance of work for that principal*" (**Principal Category**).

Under the subcontract between Choices Flooring and HY, Choices Flooring undertook to obtain public liability insurance for HY. HY was also identified as a 'principal' on a Certificate of Currency issued by the Insurer during the Policy Period.

The issue was whether HY fell into one of the above categories such that it was an "*Insured*" under the Policy and entitled to be indemnified in respect of the proceedings commenced by Mr McConnon.

## Decision

As to the Undertaking Category, the Insurer contended that the scope of any indemnity that HY might enjoy under that clause was qualified by, among other things, the context of the subcontract agreement between it and Choices Flooring, as well as the Certificate of Currency which identified HY as an "*interested party*" and as "*principal*". The argument was that HY's liability ought to be limited to any liability incurred as principal only.

The Court rejected the Insurer's argument and found that:

- the Policy did not contain any terms limiting the cover granted to HY to only those liabilities which were co-extensive with that of Choices Flooring's responsibilities under the subcontract agreement;
- the Policy expressly contemplated the inclusion of insured entities other than Choices Flooring, including by its use of the Undertaking Category; and
- an insured need not be expressly named in a Policy to enjoy the benefit of coverage (see s 20 of the *Insurance Contracts Act 1984* (Cth) (**ICA**)).

Accordingly, as Choices Flooring had agreed to obtain insurance for HY, the Court found that HY was an insured under the Undertaking Category.

As to the Principal Category, whilst not necessary to decide in light of the Court's determination above, the Court found that HY was not insured under this category because the real and efficient cause of HY's liability to Mr McConnon was its own allegedly wrongful directions to him and its liability was not relevantly caused by the performance of work by Choices Flooring (as subcontractor) for HY (as principal).

## Lessons for Policyholders

One of the key issues to consider when determining the scope of cover under an insurance policy is determining the relevant parties it insures. This decision confirms that defining an insured by reference to a class of persons can be sufficient to engage coverage, particularly having regard to the protections afforded by s 20 of the ICA. However, as evidenced by this case, class descriptions can often give rise to ambiguity. Policyholders should therefore do all they reasonably can to ensure that their name and the extent of their insurable interest in a policy are clearly recorded on the face of the document in order to minimise disputes in the event of a claim.

# Concrete denial: when does liability need to be proved?

*AIG Australia Ltd v Hanna* [2024] NSWCA 91

## Facts

The respondent, Mr George Hanna, was the named insured in a civil liability insurance policy entered into with the appellant, AIG (**the Policy**).

The Policy indemnified Mr Hanna for, among other things, all sums he became legally liable to pay as compensation for personal injury or property loss in the context of a construction project in Campsie, Sydney (**the Project**). The Policy provided that he was not to admit liability or settle any third-party claim without AIG's prior written consent.

In October 2018, a formworker on the Project was injured when he slipped and fell from scaffolding and asserted a claim for compensation against Mr Hanna.

In August 2020, after notifying the claim under the Policy, Mr Hanna disclosed to AIG's solicitor that despite being the registered builder of the Project, Mr Hanna was not in control of the site and was helping a friend who had asked him to give his builder's licence number. Mr Hanna said it was his friend who controlled the site. Mr Hanna later conceded that this was untrue and he was in fact the builder in control of the site.

On the basis of Mr Hanna's admission in August 2020, AIG terminated the Policy on the basis of fraudulent misrepresentation and non-disclosure.

In August 2021, the injured formworker commenced proceedings against Mr Hanna in the District Court alleging negligence and breach of statutory duty. Mr Hanna brought a cross-claim against AIG seeking indemnity under the Policy and damages for AIG's wrongful termination of the Policy. In support of the cross-claim, Mr Hanna gave evidence that, contrary to his previous disclosure, he was in truth the manager of the Project and had deliberately not disclosed this fact to AIG in 2020.

*Primary Judgment*

The District Court entered judgment by consent in favour of the formworker in the sum of $430,000 and gave judgment for Mr Hanna on his claim under the Policy. In making the latter finding against AIG, the primary judge held that:

1. Mr Hanna was the builder responsible for the Project and the Policy should have responded to the formworker's claim; and
2. AIG had repudiated the Policy through its wrongful termination and Mr Hanna had no choice but to accept that fact.

The primary judge found that the consent judgment had the effect of enlivening AIG's obligation to indemnify under the Policy, in circumstances where AIG's consent to this settlement outcome was not available given its earlier avoidance of the Policy.

The primary judge found that the settlement to which the consent judgment gave effect was objectively reasonable, based on a reasonable assessment of the risk that Mr Hanna faced as the defendant to the formworker's claim.

Based on expert evidence that the responsibility for the management and co-ordination of the Project fell to Mr Hanna, the primary judge also found that there was a 'substantial likelihood' that Mr Hanna would have been liable for the formworker's claim, albeit the primary judge did not decide the issue of liability due to the consent judgment.

## Decision

On appeal, the Insurer argued that:

1. as a matter of construction of the Insuring Clause, entry into the consent judgment did not activate the Insurer's liability under that clause; and
2. Mr Hanna had not demonstrated that he was liable to the formworker.

The Court of Appeal (Payne and Mitchelmore JA; Griffiths AJA) found that the Insurer had mischaracterised the primary judge's finding, which was not directed at legal liability per se, but to the reasonableness of the settlement into which the parties had entered into.

The Court reiterated the applicable principles which permitted the insured to prove its entitlement to indemnity by reference to a reasonable settlement alone, being where:

1. the contract has been wrongfully repudiated by the insurer;
2. the insured has accepted the repudiation;
3. the insured enters into an arrangement with a third party claimant to pay an amount in respect of a liability, to which, if found, the policy would have responded; and
4. the amount of the settlement is reasonable having regard to the relevant circumstances at the time, including the position in which the insured finds itself as a result of the repudiation and what it might have been held liable to pay if there had been a contest leading to a judgment or arbitral award.

In this case, as AIG was found to have wrongfully repudiated the Policy, the Court of Appeal found no error in the primary judge's approach which focused on the reasonableness of the settlement, rather than the existence of an underlying liability between Mr Hanna and the formworker. The Court of Appeal confirmed that the settlement was objectively reasonable and dismissed AIG's appeal.

### Lessons for Policyholders

This decision is a valuable illustration of the principles that apply when an insurer wrongfully repudiates a liability policy and the insured settles the underlying claim and seeks recovery from the insurer after the event. The test for recovering a settlement sum from an insurer in those circumstances is that (1) the settlement is in respect of a liability, to which, if found, the policy would have responded and (2) the settlement is reasonable having regard to all the relevant circumstances. Importantly, in such a case, a policyholder does *not* need to prove the existence of an actual underlying liability between the insured and the third party in order to recover.

# Contacts — who can help?

## Australia

**Anne Hoffmann**
Partner
T +61 2 9225 5561
anne.hoffmann@hsf.com

**Ruth Overington**
Partner
T +61 3 9288 1946
ruth.overington@hsf.com

**Guy Narburgh**
Special Counsel
T +61 2 9322 4473
guy.narburgh@hsf.com

**Andrew Ryan**
Executive Counsel
T +61 8 9211 7965
andrew.ryan@hsf.com

**Lachlan Jones**
Solicitor
T +61 2 9225 5294
lachlan.jones@hsf.com

## Asia

**Gareth Thomas**
Partner
T +852 2101 4025
gareth.thomas@hsf.com

## United Kingdom

**Sarah McNally**
Partner
T +44 20 7466 2872
sarah.mcnally@hsf.com

**Alex Oddy**
Partner
T +44 20 7466 2407
alexander.oddy@hsf.com

**Travis Gooding**
Senior Associate
travis.gooding@hsf.com

## Europe/Latin America

**Paulino Fajardo**
Partner
T +34 91 423 4110
paulino.fajardo@hsf.com

**Alejandra Galdos**
Partner
T +34 914 23 40 87
alejandra.galdos@hsf.com

A special thanks to Tristan Smith for his significant contribution to the practice and this year's 10th anniversary edition of Policyholder Insurance Highlights. Tristan will be joining the Brisbane bar in early 2025 and we wish him all the best.

**Additional Contributors to Policyholder Highlights 2024**

Nick Bartlett, Isabel Gahan, Edward Goodman and Ru Zhang

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