HERBERT
SMITH
FREEHILLS

POLICYHOLDER INSURANCE HIGHLIGHTS
2023

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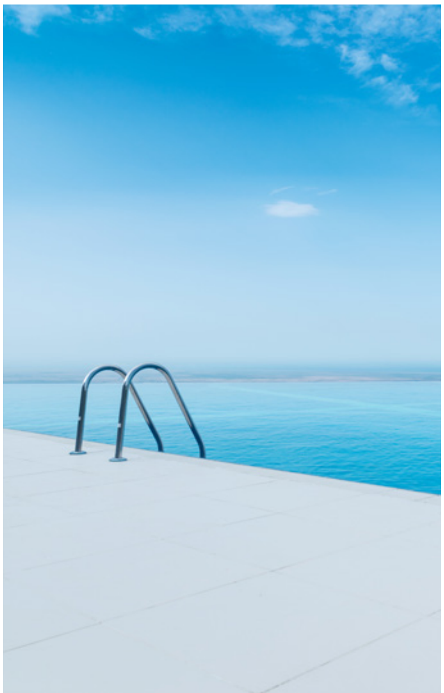

INTRODUCTION

Welcome to the ninth 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, reasonable precautions conditions, policy construction, D&O and cyber insurance.

Consistent with the trends we identified in previous editions of Policyholder Insurance Highlights, the main messages this year are:

- *Cyber risk, including cyber insurance, must be front of mind for all corporates and directors:* 2023 saw a slew of high-profile cyber incidents, as well as legal and regulatory consequences for corporate Australia which will continue into 2024. Cyber resilience is a clear target for regulators and, as a result, litigation funders and plaintiff law firms. Cyber insurance remains a complex product but the right policy can provide important protection for costs involved in responding to a cyber incident, and the liabilities which may follow — however, the product needs to be fit for purpose in the context of the high stakes and time critical nature of a cyber incident.
- *Risk increasing, but Directors' & Officers' insurance market recovering:* as reported in previous editions of Policyholder Insurance Highlights, the Australian market experienced a 3-5 year period of significant volatility and increased premiums, largely off the back of very significant liabilities arising from securities class action which could not be funded from the available premium pool. The risks in relation to securities class actions, as well as other forms of class actions to which financial lines insurance may respond (e.g. consumer claims in relation to financial products), remain. Regulatory risk for individual directors appears to be on the rise, with regulators focussed on enforcement outcomes, particularly in relation to cyber and climate change. However, despite this, there have been reports of significant premium decreases at recent D&O renewals — in the region of 20-30%, and as high as 50% — coupled with reductions in deductibles. Given the actual (or perceived) increase in underlying D&O risks, these reductions appear to be a function of the insurance market cycle — new capacity (more insurers) are entering the market seeking the higher premium income (in many cases where those insurers were not impacted by historical losses), which has increased competition and driven down prices. It is hoped that the D&O market is able to achieve greater stability going forward, rather than experiencing the well-publicised volatility of recent times.
- *Claims disputes and delays on the rise:* our observation, borne out by the numbers of judgments and cases currently progressing through the Courts, is that insurance claim disputes are on the rise. This may be a function of various things, including rising overall claim costs both as a result of increased frequency and severity, as well as the effects of inflation, and therefore an increased willingness to progress to litigated outcomes. Policyholders should use renewals to ensure their policy wordings clearly reflect the expected and intended coverage for the business (to seek to reduce the scope for dispute), and consider engaging advisers on claims at an early stage if there is potential for a dispute to arise.

We hope that you enjoy this year's edition of Policyholder Insurance Highlights. 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 in more detail.

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D&O RISK AND INSURANCE

D&O risk and market trends

In terms of underlying risk, the market is currently particularly focussed on risks falling under the umbrella term ESG (Environmental, Social, Governance), as well as cyber.

This is clear from the position taken by regulators:

- ASIC, which has demonstrated that it will pursue greenwashing breaches with various court actions and infringement notices;
- ACCC, which has been investigating and following up on the results of its website sweep for environmental claims and releases guidance;
- APRA, which has also been guiding its regulated entities to focus on climate risk; and
- The Ad Standards Board, which has been fielding a range of complaints from activist and environmental groups, with mixed success.

In addition, the Australian Government's proposal for mandatory climate-related risk disclosures is not far away, commencing from 1 July 2024 for Australia's largest companies, and work will be needed to ensure compliance.

Similarly, in relation to cyber, ASIC has identified "technological and operational resilience (including cyber resilience)" as an enforcement priority and has made statements that "cyber resilience has got to be a top priority, not just for ASIC, but for every company and every board" and if "directors did not act with reasonable care and diligence [in relation to a cyber attack], we will act".

The risks for directors flowing from these are predominantly regulatory risks, but with flow on impacts given the strong connection between regulatory activity and plaintiff lawyer and litigation funder activity.

Many market participants will be aware of the somewhat tumultuous state of the Australian D&O market in the last five years. From around 2017, it has been typified by huge premium increases, reduced availability of limits and an increase in deductibles. This was largely driven by significant liabilities for insurers arising from shareholder class actions and the historical underpricing of class action risks, resulting in an insufficient pool of money to meet liabilities. This caused some policyholders to cease buying 'Side C' (securities claim) cover, and in some cases 'Side B' (company reimbursement), or at least significantly reduce their limits. Thankfully, those premium increases have ceased, and significant premium decreases have been observed at recent renewals — around 20-30% and as high as 50% in some cases. In addition, deductibles appear to be reducing. This seems to be a result of general insurance market dynamics rather than any actual or perceived reduction in risk for directors/ companies — in short, there is increased competition in the market, particularly from London-based insurers, which is driving down premiums. As a result, some companies are re-entering the 'Side C' market and looking to increase limits where economical to do so. Premium levels seem unlikely to return to the relatively low levels experienced during the late 2000s and early 2010s, but hopefully this means that a more sustainable and less volatile D&O market can be established.

Legal developments

Notification of circumstances

Notifications of circumstances are often a critical part of a director's (and for Side C cover, the company's) protections under a D&O policy. This is because D&O policies are written on a "claims made" basis — they will only respond if the claim is made against the policyholder during the policy period (generally speaking, even if the underlying act or omission occurred prior to that policy period).

Frequently, a policyholder will be aware of circumstances during the policy period which do not themselves constitute a claim (either generally, or according the relevant policy definition). To avoid an outcome where a policyholder is not covered because (1) no claim has occurred during the policy period and (2) the known circumstances are required to be disclosed to insurers for the purpose of the policy for the following period (meaning any claims arising from those circumstances will inevitably be excluded), a policyholder has a statutory right to give "notice in writing to the insurer of facts that might give rise to a claim". In many cases, there is an equivalent contractual right under the policy. The statutory and contractual provisions mean that where "facts that might give rise to a claim" are notified to the insurer during the policy period, and a claim arises from those notified facts at a later time (including after the policy period has expired) the claim will be treated as having been made at the time the circumstances were notified (thus avoiding the coverage gap identified above).

There are a number of legal principles relating to what circumstances can be validly notified, and the required connection between the circumstances and the claim which subsequently arises. Justice Lee of the Federal Court examined and re-capped these important principles in *Uniting Church in Australia Property Trust (NSW) v Allianz Australia Insurance Limited (Liability Judgment)*,[1] albeit in the context of a series of professional indemnity insurance policies (another form of claims made policy).

The judgment is lengthy due to the factual application of the principles across many policy years, but the key principles can be summarised as follows:

- The notified facts must be objective matters which bear on the possibility of a claim being made - they cannot be subjective opinions or beliefs as to the possibility of a claim being made;
- The precise facts notified are important – a notification may fail if the notified facts, taken together, do not objectively suggest a claim is more than a potential possibility (i.e. the possibility of a claim is conditional on various matters occurring in the future);
- A notification can be of a problem which may, in and of itself, give rise to a claim by persons or entities having certain characteristics, without the insured necessarily having knowledge of the quantum of the claim or the identity of the claimants. The notification can be valid even if such claims would have limited prospects of success;
- Undertaking an objective analysis of whether a person had requisite awareness of facts which might give rise to a claim is not necessarily straightforward, and it is critical that the task is approached contextually by placing oneself in the shoes of the insured. This involves consideration of context in a broad sense and paying due regard to the particular quality and characteristics of the facts which it is said might give rise to a claim;
- As a combination of facts could form the basis for a valid circumstance notification, notifications can effectively be cumulative and include facts contained in multiple communications over multiple policy periods — an examination of the quality of the facts notified must "be informed by an eye attuned for context and historical dealings between the insured and insurer".

Justice Lee's view was also that while an opinion of a professional investigator (as opposed to the insured) may carry with it a notification of facts which might give rise to a claim, the opinion itself is not capable of constituting a "fact" capable of notification. As noted below, Justice Jackman reached a contrary view in *MS Amlin Corporate Member Limited v LU Simon Builders Pty Ltd*, namely that the existence of a particular opinion from an expert can constitute a "fact" capable of notification.

1. [2023] FCA 190.

Justice Lee's judgment makes it clear that there is considerable complexity to the making of an effective notification of circumstances.

Personal advantage

In *Hakea Holdings Pty Ltd v Neon Underwriting Limited*,[2] the Full Federal Court considered the application of an exclusion which is common in D&O policies in Australia, being for loss arising from a director "gaining any personal profit or advantage … to which he or she was not or is not legally entitled".

This form of exclusion broadly reflects the prohibition at section 199B of the *Corporations Act* on a company paying premium for insurance covering liabilities for breaches of section 182 and 183 of the *Corporations Act* (relating to the use of position or corporate information for personal advantage).

At first instance, the judge held that notwithstanding there being no allegation or finding of a breach of section 182 or 183 of the *Corporations Act* in respect of the director, the established breach of section 180 factually involved him preferring his personal interest over his duties to the company, and obtaining an improper advantage for himself (being the continuation of a building contract, the revenue from which was to be used by the director to pay personal expenses). This was consistent with the position that it is the substance, rather than form, of a claim which is relevant for the application of policy coverage.

The policyholder argued on appeal that any 'advantage' must be capable of being the subject of legal entitlement and adjudication, and also that there was nothing to show that the director was not "legally entitled" to the funds at the time they were received.

The Court held that:

- The phrase "any personal … advantage" should be construed according to its ordinary and natural meaning, which would include any matter which improves the director's circumstances or makes them better off. In this case, the phrase would extend to a commercial opportunity which may not be legally regarded as an item of property or a contractual right.
- There are potentially a number of ways to establish that an advantage is one "to which he or she was not or is not legally entitled", depending on the facts of the case. This could include showing a profit or advantage is liable to be disgorged (focussing on the lack of legal entitlement to retain a benefit once received) or that it was against the law for the director to pursue the advantage (for example, because it would be in breach of section 182 of the *Corporations Act*).

While a breach of section 182 was not advanced or found in respect of the director's conduct, the substance of the factual findings in the claim were sufficient to establish that breach, and therefore the application of the exclusion.

Fines and penalties

Many D&O policies offered in Australia provide cover for "fines and penalties" or "civil fines and penalties". There are statutory prohibitions in relation to recovering certain penalties under insurance policies (e.g. in respect of workplace health and safety breaches) and common law prohibitions in relation to indemnification of certain types of penalties depending on the underlying conduct. However, D&O policies are generally understood to have been paying these types of liabilities where permissible.

An additional form of prohibition may now arise following the Federal Court decision earlier this year in *Australian Competition*

2. *Hakea Holdings Pty Ltd v Neon Underwriting Limited for and on behalf of the Underwriting Members of Lloyds Syndicate 2468* [2023] FCAFC 34.
3. [2023] FCA 1029.

and Consumer Commission v BlueScope Steel Limited (No 6).[3] The case involved an application by the ACCC for the imposition of pecuniary penalties on Bluescope and a senior executive for attempting to induce contraventions by third parties of provisions of the *Competition and Consumer Act 2010* (Cth) by reference to an understanding with Bluescope containing cartel provisions. The ACCC also sought an order that the individual be prevented from making any claim in respect of, seeking to rely upon, or accepting any indemnity under, any applicable insurance policy for payment or reimbursement of any part of the pecuniary penalty imposed by the Court (a non-indemnification order). The individual resisted on the basis that the Court did not have power to make the non-indemnification order.

The Federal Court found that section 76(1) of the *Competition and Consumer Act* did give the Court power to make a non-indemnification order (as occurred in *Australian Building and Construction Commissioner v Construction, Forestry, Mining and Energy Union*,[4] albeit in the context of a breach of another statutory provision and not in relation to an insurance policy). Provisions in the *Competition and Consumer Act* dealing with prohibitions on indemnity (like the *Corporations Act*) but not on insurance (unlike the *Corporations Act*) were not relevant to the existence of the power. The power under section 76(1) to order the penalty where appropriate carried with it everything necessary for its exercise, including the power to make orders which are reasonably required or legally necessary to the accomplishment of what is specifically provided to be done by the statute.

The Court's decision that the making of the order was appropriate (as opposed to whether it had power) was premised on the senior executive's "central, ongoing and relentless role in the attempts to induce the price fixing understandings, his conduct during the investigation and trial, and his absence of contrition". Therefore, the order was necessary to ensure he felt the "real sting or burden" of the penalty for it to achieve the required deterrent effect — it may be that such orders could still be challenged on the basis that they are not "reasonably required or legally necessary" to achieve the objects of the statute depending on the conduct in question.

4. [2018] HCA 3.

KEEPING IT IN THE FAMILY

Admiral International Pty Ltd v Insurance Australia Ltd [2022] NSWCA 277

Facts

The Policyholder's (Admiral International) warehouse burnt down in suspicious circumstances. The trial judge found that:

- there had been arson by the father of the Policyholder's managing director, who was himself a part-time employee at the Policyholder; and
- the managing director had been complicit in that arson, based on an inference drawn from the cumulative effect of a number of matters such as the family relationship, and the managing director being overseas at the time.

On that basis, the trial judge found that there had been fraud or a breach of the clause requiring the insured to take reasonable precautions. Either conclusion disentitled the Policyholder from coverage.

On appeal, the Policyholder claimed that it was entitled to coverage, and also that it was entitled to cover for losses consequential on the insurer's failure to make payment.

Decision

The Court of Appeal held that the managing director was the controlling mind and will of the Policyholder. It further concluded there was insufficient evidence to infer that the managing director had been involved in or aware of his father's fraud. This conclusion was sufficient to defeat the insurer's fraud defence.

This finding was also sufficient to defeat the reasonable precautions defence. The Court re-iterated that a breach of reasonable precautions requires a subjective awareness of the risk by the Policyholder (and then for the Policyholder to be reckless as to that risk). As the controlling mind and will of the Policyholder, it was the managing director who had to be aware of the risk of destruction by fire — the knowledge of a part-time employee was not sufficient.

However, the consequential loss claim was rejected on the basis that damages for non-payment of damages are not legally available unless premised on a separate breach of contract — such as a breach of utmost good faith. In this case, a breach of utmost good faith had not been established as a simple failure to grant indemnity is not, alone, a breach of utmost good faith.

Lessons for Policyholders

The case highlights an important issue that can often be overlooked in cases where insurers allege a breach of reasonable precautions — who needs to have the knowledge for the insurer to succeed? Identifying this person (or group) allows a policyholder to identify the answers to two critical questions — was that person (or group) aware of the risk and did they believe they had taken adequate steps to address it?

This is an issue which a policyholder should take advice on early in a claim, as early identification of the relevant individuals is often essential in preserving evidence the policyholder may need to defeat the insurer's defence (i.e. before memories fade, or individuals move on).

DRILLING INTO THE DETAIL

Kerembla Pty Ltd v XL Insurance Company SE, trading as Brooklyn Underwriting [2023] FCA 769 and XL Insurance Company SE, trading as Brooklyn Underwriting v Kerembla Pty Ltd [2023] FCAFC 183

Facts

The Policyholder (Kerembla) specialised in exploration drilling services for coal mines. It was charged with transporting an excavator from its client's mine site to the Policyholder's workshop.

The excavator was loaded onto a prime mover and trailer. Despite careful measuring, the excavator collided with a bridge during transit.

The Policyholder brought a claim under its Public and Products Liability insurance. The insurer claimed that the vehicle exclusion operated to exclude cover, being an exclusion:

> *for Personal Injury and/or Property Damage arising out of the ownership, possession or use by You of any Vehicle… but [the Exclusion] shall not apply to:*
>
> *(d) any Vehicle (including any tool, implement, machinery or plant forming part of or attached to or used in connection with such vehicle) whilst being operated or used by You or on Your behalf as a Tool of Trade at Your premises or on any Worksite.*

The critical question was whether the write-back in (d) applied.

Decision

On its face, the write-back did not look like it would apply (such that the exclusion would apply) — as a mover / trailer would not typically be considered a 'Tool of Trade' and the incident did not occur on the 'Worksite'. However, both terms were defined.

'Worksite' meant: *'any premises or site where work is performed for and/or in connection with the Business together with all areas surrounding such premises or site and/or all areas in between such premises or site that You shall use in connection with such work.'*

The 'Business' of the Policyholder was primarily drilling but included all activities incidental thereto. The mine site and the Policyholder's workshop were premises where work was performed, and the road was an area in between those premises. Therefore, the Court concluded that the incident occurred on a 'Worksite'.

'Tool of Trade' meant: *'a Vehicle that has tools, implements, machinery or plant attached to or towed by the Vehicle and is being used by You at Your premises or on any Worksite. Tool of Trade does not include [a] any Vehicle whilst travelling to and from a Worksite or [b] Vehicles that are used to carry goods to or from any premises.'*

On the 'Tool of Trade' definition, the Court concluded that:

- 'to and from a Worksite' suggested travel from or to a place that is not a Worksite (not between parts of the same Worksite). Therefore, [a] did not apply; and
- tools, implements, machinery or plants attached to or towed by a vehicle will invariably be 'goods'. As such, a literal reading of [b] would leave the term 'Tool of Trade' with little or no operative effect. As such, despite its broad language, [b] was read down so as to not include the transporting of 'things attached to or towed by the Vehicle'. The excavator was secured to the trailer with a chain and so was 'attached to' the mover/trailer. As such [b] also did not apply.

The consequence was that the mover/trailer was a Tool of Trade being used on a Worksite and the vehicle exclusion did not apply.

The insurers appealed the decision. However, the Full Federal Court rejected the appeal, agreeing with the trial judge's reasons and interpretation.

Lessons for Policyholders

This case is a good example of the devil being in the detail and is an interesting contrast to the *Acciona* decision (see page 18) as an example of a more technical argument prevailing.

On its face, the claim involved a vehicle and the exclusion appeared to apply. It is easy to imagine a claim not having been brought at all. It is therefore important to carefully work through the policy coverage and the detail of the definitions at an early stage, preferably with the benefit of legal advice.

POOLING OF RISK

Flanagan v Bernasconi [2023] NSWCA 150

Facts

The Policyholder's (Mrs Flanagan) home included a 25-metre swimming pool. In 2013, the pool (which was empty) lifted out of the ground during a heavy rain event.

Essentially, the water pressure in the surrounding ground built up due to the rain. This pressure ought to have been relieved by a hydrostatic valve, but it did not function (due to a defect). Without the weight of water in the pool, the water pressure caused the pool to 'pop out' of the ground.

The Policyholder's homeowners' insurance excluded damage to the pool and did not respond. The Policyholder brought a claim against her insurance broker, who had arranged the policy.

The broker conceded it had breached a duty of care by not advising the Policyholder of the existence and effect of the pool exclusion. However, at first instance, the Court found that that breach had not caused any loss on the basis that the alternative policy the broker could have arranged would have contained:

- an exclusion for defects, which would have excluded this claim due to a defective valve; and
- a reasonable precautions clause, which would have been breached by the Policyholder's decision to keep the pool empty.

We included the trial decision in our Policyholder Highlights publication last year (here), and also separately published a more detailed article on the decision (here). We are now reporting on the appeal decision which affirmed the lower court's decision.

Decision

The Court of Appeal dismissed the Policyholder's appeal. The onus was on the Policyholder to prove that the alternative policy would have provided cover had it been obtained. As part of that, the Policyholder bore the onus to prove that the exclusions and conditions negating cover would not apply. The Policyholder had not discharged this onus.

In relation to the defects exclusion, there was sufficient evidence that the valves were defective. The Court also expressly noted that it did not matter that the valve had not been defective when it was installed — it was sufficient that the defect arose after installation.

In relation to the reasonable precautions clause, the Court identified an email from the Policyholder's former partner that expressly noted the danger with leaving the pool empty: *"You will be aware of the danger in this with cracking due to outside compression and of its 'popping up' as the underlying clay dries out"*.

This was held to be sufficient to put the Policyholder on notice of the risk which eventuated, such that the Court held that her complete failure to address the risk breached the reasonable precautions clause (because by failing to do anything she had effectively acted recklessly).

Interestingly, the email identified:

- the same consequence as eventuated should the Policyholder fail to fill the pool; but
- that it may occur due to a different mechanism. That is the email identified the risk of the pool popping out due to the ground drying out (too little water), whereas the pool popped out due to water pressure building up in the ground (too much water).

However, this difference was insufficient to assist the Policyholder.

Lessons for Policyholders

Claims against brokers are challenging because, in some respects, it is two claims in one. The Policyholder has to show that the broker was negligent AND (but for that negligence) they would have been insured for their loss under a hypothetical alternative policy.

It is also important to remember that the onus is on the Policyholder to prove such a case, which changes the Policyholder's typical position from that in an insurance claim — the Policyholder must prove that the exclusions in the hypothetical policy would not apply (as opposed to the insurer typically having that burden).

A TALE OF TWO INDEMNITIES

FKP Commercial Developments Pty Ltd v Zurich Australian Insurance Limited [2022] FCA 862 and FKP Commercial Developments Pty Ltd v Zurich Australian Insurance Ltd (No 2) [2023] FCA 582

Facts

The First Policyholder (**Principal**) developed two residential apartment buildings. It appointed the Second Policyholder (**Contractor**), a related entity, as the head contractor for the development. The Contractor engaged consultants and subcontractors to perform all the design and construction work. The only work carried out by the Contractor was project management.

The body corporate of the new buildings brought a claim against the Policyholders claiming losses caused by alleged defects in the common property of the buildings in breach of the statutory warranties in the *Home Building Act 1989* (NSW). The alleged defects arose in relation to the work carried out by the consultants and subcontractors.

The Policyholders were insured under a Design and Construction Professional Indemnity policy which insured (**First Indemnity**):

> *We agree to indemnify the insured against loss incurred as a result of any claim for civil liability first made against the insured and notified to us during the period of insurance, based on the insured's provision of the professional services.*

The policy separately insured (**Second Indemnity**):

> *We agree to indemnify the insured for loss resulting from any claim arising from the conduct of any consultants, sub-contractors or agents of the insured for which the insured is legally liable in the provision of the professional services. No indemnity is available to the consultants, sub-contractors or agents.*

The insurer denied the claim and the Policyholders began proceedings. The parties referred a separate question to the Court in relation to whether the First Indemnity applied on a set of assumed facts.

Decision(s)

In the separate question as to whether the First Indemnity provided cover, the insurer accepted that the provision of project management services was 'professional services'. However, the insurer contended that not all of the Policyholders' liability was based on the Policyholders' provision of 'professional services'.

Justice Jagot concluded that to be insured the liability must 'depend on' the Policyholders' provision of professional services. However, the claim against the Policyholders did not necessarily depend on the Policyholders being negligent in their provision of project management services — rather it depended on the fact that they contracted for residential building works to be done on the land. The Policyholders would have been liable whether or not professional services were provided. Therefore, on the assumed facts, the First Indemnity did not apply.

The Policyholder tried again, bringing a further separate question in relation to the Second Indemnity.

Justice Jackman held that the Second Indemnity did not require the same causal link between the liability and the provision of professional services as the First Indemnity. That is, coverage under the Second Indemnity did not require that liability be 'based on' or 'depend on' the provision of professional services, just that the liability will arise 'in the provision of' professional services. The Second Indemnity clause was broader and extended to cover the Policyholder's liability for the conduct of consultants, sub-contractors or agents who were providing professional services.

Therefore, the Policyholder was insured under the Second Indemnity.

Justice Jackman's decision was unanimously upheld on appeal by the Full Court of the Federal Court (Justice Lee, Justice Stewart and Justice Cheeseman) in *Zurich Australian Insurance Ltd v FKP Commercial Developments Pty Ltd* [2023] FCAFC 188.

Lessons for Policyholders

It is possible (if not probable) that the Second Indemnity was not relied on at first instance before Justice Jagot due to a separate limit applying. However, the cases do highlight that in complex situations, a lot of time and confusion can often be avoided in a claim by taking a very clear (and, to the extent possible, simply explained) position on the elements and causal steps required to trigger cover. Even slight nuances in each insuring clause can be significant, making early legal advice crucial.

WHO PAYS AT THE END OF THE DAY?

WSP Structures Pty Ltd v Liberty Mutual Insurance Company t/as Liberty Specialty Markets [2023] FCA 1157

Facts

Sydney's Opal Tower suffered severe structural damage in 2018. This led to three sets of legal proceedings in NSW, which were all settled in 2022. One of the settlement parties was the Policyholder (WSP), who was the structural engineer engaged by the head contractor.

Part of the settlement payment for the Policyholder's potential liability was made by its holding company and part by its professional indemnity insurers. The Policyholder also brought a claim under its 'Third Party Liability' policy (i.e. a public liability insurance policy covering liability for third party property damage amongst other things), for the part of the settlement amount paid by the holding company. That policy insured 'Subcontractors'. It also insured 'Engineers, but only in relation to their manual on-site activities'.

The third party liability insurer disputed the claim on the basis that the Policyholder:

- was an engineer, but did not have any manual on-site activities, and the carve-out of manual on-site activities from coverage for engineers should, by implication, mean they were not insured in their capacity as subcontractors for manual on-site activities;
- had elected to claim from its professional indemnity insurer (including for the amount paid by the holding company), so now could not claim from the third party liability insurer; and
- had already been compensated by its holding company so had no loss.

Decision

The Court rejected that the limitation of cover under the policy for 'engineers' should be applied to 'subcontractors'. Each listed 'insured' was separated by the words 'and/or' implying they could be both. Further the limitation on engineers would still have meaningful effect to persons engaged directly by the project Principal (i.e. that were contractors rather than sub-contractors). As such, the Policyholder was an Insured under the policy.

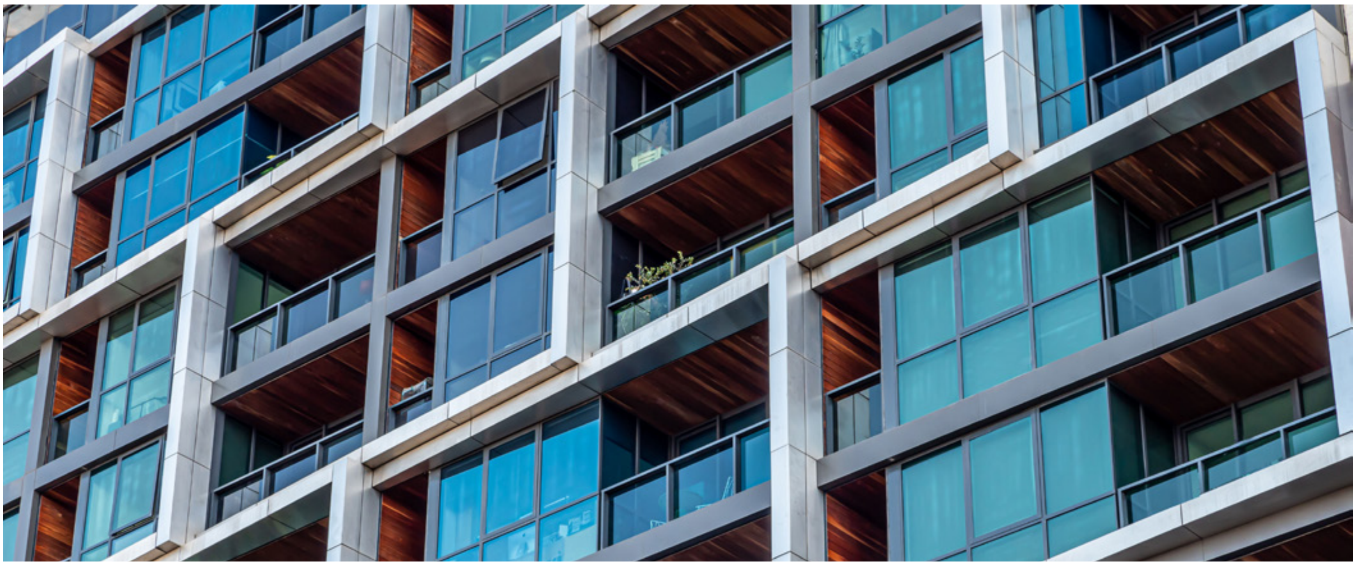
The Court rejected that there had been an election (between the professional indemnity policy and public liability policy) which impacted the Policyholder's claim. Consistent with section 76 of the *Insurance Contracts Act 1984* (Cth), until such time as the Policyholder is *actually* paid by one insurer for the loss it can continue to claim that same loss from another insurer. Once it had been paid for that loss, the Policyholder lost the ability to claim against the second insurer because it had no longer suffered a loss in respect of the amount actually paid by the first insurer (not due to the doctrine of election).

Further, the payment by the holding company did not diminish/extinguish the Policyholder's loss for the purpose of claiming under the policy. The holding company was simply the source of funds used to make the payments. The Policyholder continued to have a loss and continued to be the correct claimant under the insurance policy.

Lessons for Policyholders

Although a favourable outcome for policyholders, the case highlights the insurance risks involved in one member of a corporate group paying the liabilities of another.

This can be done in a way that does not prejudice the insurance claim, but care should be taken at the time of making the payment to ensure the insurance position is protected.



THE LOST NOTIFICATION OF ATLANTIS

MS Amlin Corporate Member Limited v LU Simon Builders Pty Ltd [2023] FCA 581

Facts

The Policyholder (LU Simon) had constructed several high-rise building complexes, including the Lacrosse Apartments and the Atlantis Towers.

On 25 November 2014, the Lacrosse Apartments infamously caught fire. The fire spread rapidly due to the combustible aluminium composite panels (ACPs) used as cladding on the buildings. This triggered a series of investigations and claims in relation to the use of cladding more broadly, including three claims in relation to the use of cladding in the Atlantis Towers.

On 5 May 2015 and 14 May 2015, the Policyholder's brokers sent an email to its civil liability insurers under the subject line 'Potential Claim'. The emails did not expressly identify that there was a risk of claims in relation to Atlantis Towers or that Atlantis Towers had used ACP.

However, the emails did include newspaper articles about the Lacrosse Apartment Fires, a report into that fire by the Metropolitan Fire Brigade and a report by the Municipal Building Surveyor of the City of Melbourne. The reports included some expert opinions about the use and dangers of ACPs.

Each document included in the emails focused on the Lacrosse Apartments and the brand of ACP used in that complex. However, they also made reference to the broader usage of, and investigations into, ACPs.

The claims in relation to the Atlantis Towers arose after the policy period. As a result, the Policyholder sought to rely on these emails as being notifications of circumstances so as to be insured for the subsequent claims under the policy on foot at the time of the circumstance notification pursuant to section 40(3) of the *Insurance Contracts Act 1984* (Cth). Insurers denied the claim in relation to the Atlantis Towers on the basis that the earlier circumstance notification had not been sufficient for section 40(3) to operate.

Decision

The Federal Court held that there had been sufficient notification of circumstances - the documents notified disclosed the existence of a wider problem concerning the use of non-compliant and unsafe ACP products on other buildings in Australia (including those constructed by the Policyholder) which was enough for section 40(3) to operate.

In reaching this conclusion, the Court placed weight on:

- the newspaper article, which included comments from the Managing Director of the Policyholder that at the time of construction of Lacrosse Apartments in 2010 there had been no cladding product that passed Australian Standards for combustibility;
- the proposal form used when the Policyholder entered into the relevant policy which identified that 100% of the Policyholder's work related to high-rise buildings (i.e. which provided context for the newspaper article suggesting that this was an issue for the Policyholder's other buildings); and
- expert opinions included in the reports. Earlier this year, Justice Lee, also in the Federal Court, held that expert opinion was not a 'fact' for purposes of notification (see *Uniting Church v Allianz* in D&O Risk and Insurance – Legal Developments above). Justice Jackman expressly disagreed and found that the fact that an opinion has been given by a person with appropriate expertise is itself a fact capable of being notified as a circumstance.

It did not matter that the potential claimants were not identified or that the Atlantis Towers used a different brand of ACP.

Lessons for Policyholders

The facts of this dispute emphasise for policyholders the importance in framing notifications in the context of specific legal thresholds. Prior to giving a notification a policyholder should seek advice on their potential exposures and then ensure that it is providing its notification in a way that clearly encompasses those exposures so as to minimise the risk of controversy if a claim subsequently arises.

Although the case is favourable to policyholders, the disagreement between two judges of the same court in the same year as to whether expert opinion is a 'fact', also demonstrates the importance of seeking legal advice when preparing a notification.

SUBSTANCE OVER FORM

Prestige Form Group NSW Pty Ltd v QBE European Operations PLC [2023] FCA 749

Facts

The Policyholder (Prestige) was a formwork contractor engaged by the head contractor to provide formwork and associated works in a building. The Policyholder completed the formwork in the basement, but the formwork subsequently failed while concrete was being poured into it by a third-party contractor. This caused damage to the floor below.

The Policyholder brought a claim under its 'Qanta Contractors Liability Policy' for its liability to the head contractor. The Policy excluded: *liability in respect of damage to property which consists of or forms part of the Contract Works.*

"Contract Works" was defined to mean: *engineering, construction, electrical or mechanical, installation or erection works, including formwork, hoardings, temporary buildings or works, scaffolding, principal supplied or free issue materials, materials for incorporation in the works and additions, alterations, refurbishing or overhaul of pre-existing property.*

The Policyholder argued that the exclusion should be limited to apply to Contract Works owned by or in the possession of the Policyholder.

Decision

The Court concluded that the Policyholder's interpretation was overly narrow.

The mere use of "the" prior to 'Contract Works' did not support the distinction proposed by Prestige in light of the natural and ordinary meaning of the defined term. Further, the interpretation was incompatible with other exclusions in the policy, which clearly specified whether property being in the Policyholder's possession or control was relevant to the operation of the exclusion.

As a result, the Policyholder was not insured.

Lessons for Policyholders

The policy was presumably taken out on the assumption that it excluded cover for the Policyholder's own contract works (for which separate first party insurance policies are common) but covered general liability to others for damage to their property (including their contract works).

As the Policy did not work in this way, it revealed a gap in coverage — and an important one — as, if damage occurs on a site, it is likely to involve the contract works of others. Policyholders should be mindful of this and should seek advice as to whether they may be exposed to the same gap.

WHEN IT RAINS, IT POURS

Acciona Infrastructure Australia Pty Ltd v Zurich Australian Insurance Limited [2023] FCAFC 47

Facts

The Policyholder (Acciona) was upgrading a 19.5km road which extended both north and south of the Nambucca River. The entire stretch of road suffered rainfall and flooding damage.

The project was insured under a Construction All Risks policy. However, that policy did not cover damage due to rain except where the damage was due to a 20-year (or greater) rainfall event for the location insured based on the Bureau of Meteorology (BOM) statistic 'for the nearest station to the location insured'.

The rainfall station:

- south of the river, which was closer to the road as a whole, measured an event that met that requirement; but
- north of the river, which was closer to the damage that occurred north of the river, measured an event that did not meet that requirement.

Insurers therefore argued that damage north of the river was excluded. This question of interpretation was referred to the Full Court by the Federal Court.

Decision

The Policyholder sought to equate the phrase 'location insured' with the definition of the 'Project Site' — essentially being the entire road. On that basis, it argued that the BOM reading of the south station should apply, as it was closer to the road (even if it was further away from the damage to the northern part of the road).

The Full Court, though accepting that the phrase 'location insured' was not clear, agreed with the insurer's interpretation. It held that, as a matter of 'common sense', a clause allowing cover for damage by reference to rainfall heaviness would relate to rainfall heaviness in the area of the damage. If the parties intended to refer to the entire Project Site (not just the area of the damage) then, instead of using 'insured location' it could have used the defined term 'Project Site' which had that meaning.

Further, on the Policyholder's interpretation, if a sufficiently intense rainfall event:

- caused the damage; and
- was recorded at the BOM station nearest the damage; but
- was not recorded at the BOM station which was distant from the damage but was closer to the part of the road, then the Policyholder would not be insured.

That is, regardless of how intense the rainfall was at the location of the damage, if a station that was many kilometres away did not also experience that rainfall, the Policyholder would not be insured. This was said to be an 'unbusinesslike' outcome, that suggested the Policyholder's interpretation should be rejected.

Lessons for Policyholders

When in doubt, test your interpretation against other factual scenarios and question whether the outcomes achieve what appears to be the intention of the clause viewed from a businesslike, common sense perspective. That said, views of 'common sense' and 'businesslike interpretation' can differ — this is why there is always a risk associated with litigating policy construction disputes. Wherever possible, policyholders should seek to achieve clarity in policy wordings ahead of time.

CYBER UPDATE

Cyber has continued to be a buzz word in 2023 as businesses continue to look for ways to mitigate the risk of losses arising from cyber-related incidents.

In the market, we have been seeing:

- **More Policyholder Focus:** The recent uptick in major cyber incidents globally has sharpened the focus in boardrooms on implementing a range of cyber-risk mitigation strategies in their businesses. There is increasing acceptance of the fact that it is no longer a question of "if" but "when" a cyber incident will occur. As part of contingency planning, policyholders are looking closely at their insurance policies to understand what coverage they may have to mitigate the financial fallout from a major cyber incident. In response to business demand for tailored cyber insurance products, there is a pronounced migration to standalone cyber insurance policies, designed to help businesses protect themselves from the specific financial and legal consequences of cyber-attacks, data breaches, and other cyber-related incidents. Policyholders are increasingly looking to these types of insurance products to build financial resilience within their businesses in tandem with continued investment in their systems and IT security.
- **More Complex Policies:** As the range of cyber threats and consequences expand, the complexity of cyber policies has increased. This is a function of the relative immaturity of the cyber insurance market and the volatile and evolving nature of the risk (compared to, say, D&O risk and insurance). Cover is provided through very specific insuring clauses, often by reference to complex and, in some cases, narrow definitions — this assists insurers to price policies having greater certainty over the risks being covered. However, this may result in a 'square peg in a round hole' scenario in the event of a claim, as a policyholder may have to argue that a novel form of cyber event falls within an insuring clause that is not a 'comfortable fit' — potentially leaving them without cover. The expanding scope of cyber cover offered by the market to meet new threats as they emerge (and become better understood) should help to reduce this risk, but it remains vital for policyholders to understand the evolving threat landscape and ensure their cover keeps pace as best they can.
- **Cyber War Exclusions:** Presumably in response to the recent *Merck v ACE American Insurance* decisions in the US (discussed below) and the increased threat of cyber-attacks by hostile state actors, Lloyd's has introduced new standard form cyber war exclusions for its underwriters, which are increasingly being adopted by the broader market. The rationale for including these exclusions is based on concerns that a state-sponsored cyber-attack involving widespread impact across multiple organisations is a systemic risk that could potentially affect the insurance market's ability to pay any covered losses. Therefore, it ought to be excluded in a similar way to catastrophic events such as pandemics and nuclear incidents. We are seeing policyholders seeking advice on the meaning of these

exclusions and the meaning of the 'attribution clauses' which often accompany them (i.e. how to establish a cyber-attack is an act of war by a hostile state actor). In a similar vein, we are also seeing an increase in policies making distinctions between events directed at individual policyholders and events which have broader impacts which happen to affect individual policyholders.

In light of these developments there are a number of cyber risk issues for policyholders to conside going into 2024:

- **Investment in Cyber Resilience:** Regardless of whether or not an organisation has cyber insurance, the biggest risk remains not having adequate systems in place to ideally prevent but also recover from a cyber incident. There are a variety of steps that cyber specialists will advise policyholders to implement. Other than actual IT security steps, we would emphasise the importance of not just having an incident response plan but also making sure that key decision makers are trained in that plan — so that everyone knows who should be doing what in the event of an incident. Cyber insurers are increasingly requiring evidence that policyholders have detailed IT security measures in place as a pre-condition to offering cover.
- **Definitional Risk:** The increase in policy specificity has brought an increase in complexity and the risk that the very detailed wording used may not apply to the specific circumstances (ironically the very risk that the increased specification in types of cover seeks to avoid). In this respect, cyber policies can be contrasted with a typical property damage / business interruption policy. In that situation the insured event is well understood and so can be simply and broadly defined — typically the occurrence of physical damage. Although the understanding of cyber events has been increasing, the risks remain insufficiently understood to be defined by simple and broad terms (as insurers cannot be sure of the scope of the risk that they are taking on). For that reason, it is important to spend time to understand the coverage provided in detail. We have been assisting a number of policyholders to stress test their policies against potential loss scenarios.
- **Silent Cyber:** When cyber risk has the potential to affect all areas of business and result in significant financial, operational, and reputational losses, recoveries may be drawn from a range of insurance policies. These losses may fall within the scope of traditional policies such as D&O liability, fraud/crime liability, public liability and even property damage and business interruption policies in some instances. Insurers have, however, been working to exclude so-called "silent" cyber coverage (ie, non-express cover for cyber-related losses available in traditional liability/ property policies) in appropriate cases, and the scope of coverage available in those policies depends on policy terms.

We expect exclusions for "silent" cyber to continue as insurers seek further certainty on what their policy wordings are intended to cover.

- **Cyber Response Teams:** While part of the benefit of a cyber policy is access to the insurer's cyber response team, it is important not to assume that this is the only option available. A cyber response plan should be adapted to the needs of the particular policyholder depending on its business activities and the specific risks faced in their sector/industry. There may be advantages to having a list of preferred cyber advisers separate from those recommended by insurers and this is a matter that should be considered when developing a cyber response plan.
- **Business Interruption Cover:** We are also seeing a divergence in approaches to business interruption cover for turnover lost due to a cyber event. Some insurers seek to assert that the claimable loss ends with the restoration of the computer systems — allowing nothing for 'ramp up'. Other policies we have seen expressly deal with this issue by allowing defined 'ramp up' periods or defined periods of cover for reputational harm. The reality is that different businesses are affected by cyber events in different ways and security ramp up cover may be more important for some business models than others.
- **Regulatory Risk:** We are seeing an increase in the policies which provide cover for regulatory fines and the costs of responding to a regulatory investigation. However, at times, this cover will be limited to privacy-related breaches / investigations. It is important to ensure any cover is fit for purpose having regard to the range of possible regulatory scenarios that may affect a policyholder's business.

Read more insights from HSF's 2023 Cyber Risk Survey here.

International Case Update

As judicial determinations on cyber insurance policies remain rare in Australia, overseas decisions can assist in illustrating the emerging law in the area.

Merck v ACE American Insurance

As mentioned above, this year saw the latest judgment in this long-running cyber loss claim by major pharmaceutical company Merck & Co Inc for more than USD $1.4 billion in losses from the 2017 'NotPetya' ransomware attack it suffered.

Merck had claimed under its all risks policy, which covered loss or damage resulting from destruction or corruption of software. Because the widespread 'NotPetya' attack occurred in the context of conflict between the Russian Federation and Ukraine, insurers sought to rely on the standard 'hostile or warlike action' exclusion, contending that the malware attack (carried out by Russia-linked operatives) was an action of the Russian Federation.

Merck won summary judgment at first instance, on the basis the exclusion did not apply, but insurers appealed the interpretation of the clause.

The Appellate Court affirmed the primary judgment in Merck's favour, ruling that the plain meaning of the exclusion required actions 'clearly connected to war or, at least, to a military action or objective', consistent with older, pre-cyber cases on this exclusion. Since the 'NotPetya' attack, even if politically motivated, was not part of a military action or objective, the exclusion did not apply.

This decision is under further appeal.

EMOI Services v Owners Insurance

The Policyholder (EMOI) provided software for medical centres, and some of its software was unrecoverable after a ransomware attack. It claimed under an electronic equipment endorsement to its businessowners' insurance policy, which covered 'direct physical loss or damage to "media"'. 'Media' referred to physical storage media (eg hard drives).

The Supreme Court of Ohio held that the electronic equipment endorsement did not cover loss or damage to software, as software could not suffer 'physical' loss, and no physical damage had occurred to any equipment.

This is a reminder of the potential gaps in coverage for cyber risks, particularly under non-cyber specific policies, and the need to ensure that the key risks to the business (here, software losses rather than hardware losses) are aligned with the scope of coverage.

Yoshida Foods International v Federal Insurance

The Policyholder (Yoshida) was insured under a crime policy for 'Computer Fraud', including 'direct loss' caused by 'unlawful taking' of money resulting from a 'computer violation'.

Yoshida suffered a ransomware attack, and (via an executive making the payment) paid US$100,000 in ransom to restore its systems, which it then claimed under the policy. The insurer contended that the loss was not a 'direct' result of the unlawful taking of money, because Yoshida had a choice about whether to pay the ransom and paid it voluntarily.

The US District Court rejected the insurer's argument on the basis there was no real choice about whether to pay the ransom, so the loss was 'direct' and an 'unlawful taking' of money.

The decision has been appealed.

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HSF Australia Policyholder Team Update

Three updates on our team for our valued clients.

First, in May 2023, as you may know, Anne Hoffmann was promoted to Partner in our Sydney Disputes group. Anne is a globally experienced dispute resolution lawyer with a particular focus on the financial services and insurance sectors.

Anne has acted for policyholders on claims and coverage issues in relation to many types of insurance including professional indemnity, D&O, cyber and crime.

Through secondments to an insurance broker and two major Australian financial institutions, she has a strong understanding of the sectors in which her clients operate which has guided her involvement across a range of complex litigation matters for clients in Australia, and globally.

Secondly, after a long and distinguished career, Mark Darwin retired from the HSF partnership in April 2023. He continues to support the practice in a part-time Senior Adviser role.

Mark has been a recognised leader in the policyholder claims space for many years, having successfully acted for many of the firm's largest clients, including BHP, Toll Holdings, Santos, Newcrest and Prime Infrastructure, on some of the most significant and complex insurance claims in the Australian market, as well as maintaining a thriving general disputes practice.

Under his leadership, the HSF's Australian policyholder practice has climbed into the top rankings in Chambers and Asia-Pacific Legal 500.

HSF and the policyholder insurance team thank him for his outstanding contribution to the policyholder insurance practice and firm more generally, and wish him the best for his retirement from the partnership.

Mark leaves the practice in Anne's and the broader team's very capable hands, and looks forward to spending more time on the golf course in between carving out the next stage of his career as a mediator.

Finally, Travis Gooding, who has been an important part of the Australian practice and instrumental in this and other editions of Policyholder Highlights, will be moving to our market-leading London insurance team to expand his experience. We thank him for his contribution and wish him the best of luck. Tristan Smith (who returned from our London insurance team last year) will be expanding his insurance role.

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