ANALYSE

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Cover to Cover

Issue 29

Our publication for New Zealand insurance professionals

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Foreword

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Welcome to our final issue of *Cover to Cover* for 2023 – our publication for New Zealand's insurance professionals.

In this *Cover to Cover,* we delve into climate-related disclosures (CRD) and provide a summary of the CRD regime's requirements for climate statements. We provide useful guidance to insurers on the steps they can take now to prepare for the CRD regime and maintain compliance with its framework.

Following New Zealand's largest cyber breach to date, both the Financial Markets Authority and the Reserve Bank are now taking a close interest in what regulated businesses are doing to protect themselves and their customers. We analyse the standards that these regulators have introduced and what they mean for financial service providers, including insurers.

The Insurance Council of New Zealand expects insurers to make a total of $3.5 billion in claims payments for all claims for the Auckland Anniversary Floods and Cyclone Gabrielle. With extreme weather events becoming more common, highlighted by both of these weather events, we examine the future of insurance cover for climate-related natural disasters. We also look at the response from insurers and examine the possibility of Government intervention.

Finally, we share recent case studies from the English High Court; one examines the rejection of the "but for" test again, while the second provides new guidance on warranty and indemnity insurance claims.

We hope you find this issue insightful and useful.

Preparing insurers for climate-related disclosures

Authored by Lloyd Kavanagh, Partner and Hannah Cross, Solicitor

The insurance industry is already alive to the physical effects of climate change, with the early weather events in early 2023 being one instance of extreme weather causing damage to policyholders' homes and businesses. Insurers are also thinking about the transition impacts: the more subtle but equally powerful market forces and government responses to the threat of climate change – examples of this range from the rapid growth in new electric vehicle registrations to the requirement for default KiwiSaver providers to exclude fossil fuel investments.

Insurers are also facing the mandatory framework requiring climate-related disclosures (CRD) by climate reporting entities (CREs) under Part 7A of the Financial Markets Conduct Act 2013 (FMCA). The ultimate aim of the prescribed disclosures is to "support the allocation of capital towards activities that are consistent with a transition to a low-emissions, climate resilient future.[1]"

In this article, we summarise the CRD regime's requirements for climate statements and offer some practical recommendations for insurers as to what they can do now to prepare for the CRD regime and to ensure compliance with the CRD framework.

1 According to the objective of NZ CS1

Climate-related disclosure: The core obligations

Most insurers who are CREs will already be well into their first reporting period, given the requirements to prepare and lodge climate statements take effect for accounting periods that start on or after 1 January 2023. For example, insurers that are CREs with a 31 December balance date will be lodging their first climate statement by 30 April 2024, in respect of the 2023 reporting year.

The definition of CRE captures, among other 'large' entities, licensed insurers that have over $1 billion in assets or premium income over $250 million per annum. Under Part 7A, CREs have some key obligations:

1. Annual climate statement

Prepare an annual climate statement in in accordance with the climate-related disclosure framework. These are the External Reporting Board (XRB) issued Aotearoa New Zealand Climate Standards 1, 2, and 3 (NZ CS). NZ CS 1 contains the core requirements across four main pillars: Governance, Strategy, Risk Management and Metrics & Targets. NZ CS 2 deals with transitional provisions, and NZ CS 3 contains the general requirements and principles.

2. Lodging climate statements

Lodge the climate statements on the incoming Climate-related Disclosures Register four months after a CRE's balance date. Climate statements will also need to be linked in a CRE's annual report. However, the FMA (Financial Markets Authority) has agreed in principle to grant a two-year exemption from this requirement to include such a link for CREs that are required to publish their annual reports within three (rather than four) months of their balance date under other legislation.

3. Greenhouse gas emissions disclosures

For periods ending on or after 27 October 2024: Obtain independent assurance over greenhouse gas emissions disclosures (typically this will be a CRE's second reporting period).

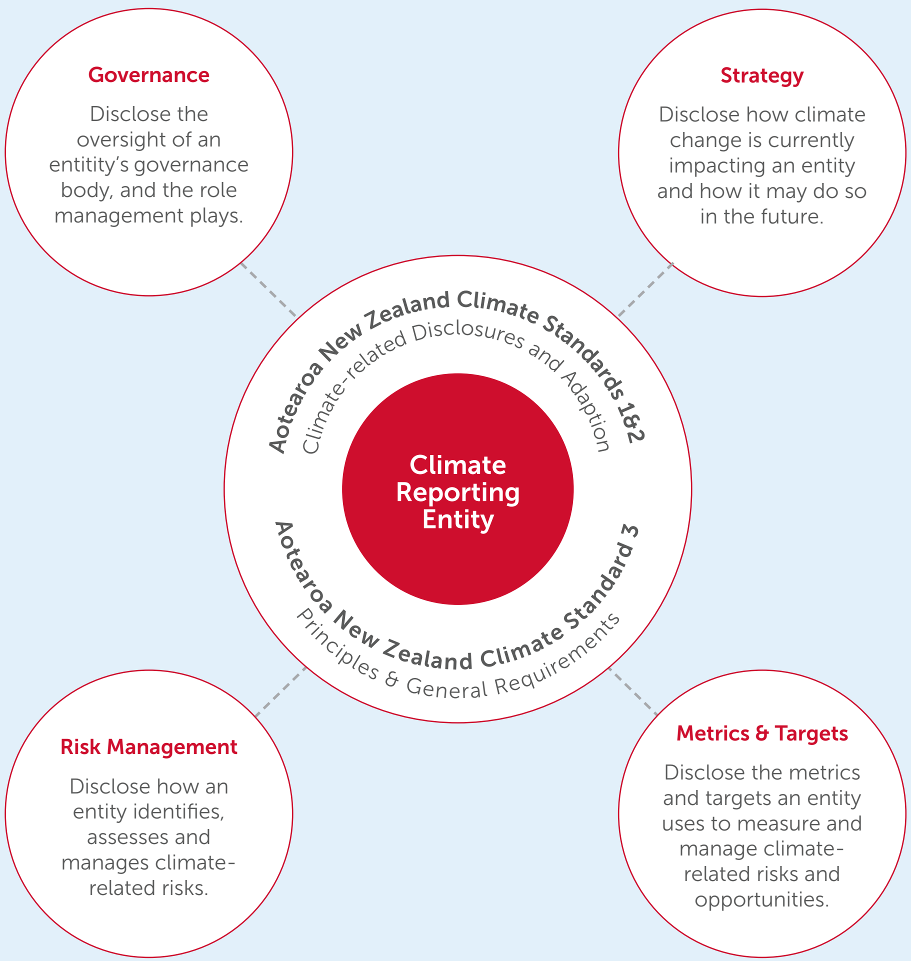
4. Record keeping

Keep proper records to support your climate-related disclosures. Record keeping requirements are prescribed in the Financial Markets Conduct Regulations 2014 (FMC Regulations) that came into force on 2 October 2023.

Compliance with the CRD regime is no easy feat, and extensive work is required from a wide variety of teams and roles within a CRE's business. Insurer CREs across the industry are each on their own climate reporting journey, and they will be at varying levels of readiness.

An important point to remember about the CRD regime is that it is not intended to be a 'tick-box' disclosure exercise. It is intended to benefit CREs by developing their climate resilience, and informing relevant stakeholders. The NZ CS requires CREs to consider both climate-related risks and opportunities for their business and how they can best manage these to ensure they can adapt to, or even thrive in, the changing climate.

Four pillars of the Taskforce for Climate-related Financial Disclosure (TCFD)



Source: XRB All Sectors Staff Guidance

Climate statements: NZ CS

The major features of the CRD regime are derived from the Taskforce for Climate-related Financial Disclosure (TCFD) Recommendations and require disclosures based on the TCFD's four pillars, being:

- **governance:** enabling users to understand the role of the governing body (usually the board) in overseeing, and management in assessing and managing, climate-related risks and opportunities;
- **strategy:** enabling users to understand how climate change is currently impacting an entity and how it may do so in the future;
- **risk management:** enabling users to understand how an entity's climate-related risks are identified, assessed, and managed, and how those processes are integrated into existing risk management processes; and
- **metrics & targets:** enabling users to understand how an entity measures and manages its climate-related risks and opportunities (including scope 1, 2 and 3 greenhouse gas emissions).

"The major features of the CRD regime are derived from the Taskforce for Climate-related Financial Disclosure (TCFD)"

Key to the approach is a scenario analysis requirement. NZ CS 1 requires the CRE to consider, at a minimum, three climate-related change scenarios:

- a 1.5°C scenario;
- a 3°C or greater scenario; and
- a third scenario chosen by the CRE.

The outputs of a scenario analysis will identify the climate-related impacts which the governing bodies of CREs must then factor into their risk management and strategy disclosures. That is what is expected to drive both adaption and mitigation by the CREs. Importantly, the scenario analysis does not require the CREs to predict which, if any, of the scenarios is more likely. Instead, the scenarios are intended to provide a range of narratives to expand understanding of the spectrum of outcomes which are possible.

The roles of the XRB and the FMA

The two key parties involved in the CRD regime are the XRB and the FMA. The XRB has responsibility for consulting on and issuing climate standards, with an extended function relating to the issue of auditing and assurance standards, and non-binding guidance.

The FMA, as regulator, is responsible for independent monitoring and enforcement of the CRD regime, as well as providing guidance about compliance expectations. It has powers in relation to enforcement, regulations, and exemptions for CRD requirements. Accordingly, once the NZ CS have been issued, it is to the FMA that insurers should look to understand how the regime will be applied to them.

XRB Guidance

The XRB has issued the three NZ CS referred to above. These standards have mandatory status and you must read them together. In particular, NZ CS 3 is important to understand how NZ CS 1 will be applied.

In addition, the XRB has released various guidance, such as the All Sectors Staff Guidance and the Entity-level Scenario Analysis Staff Guidance. These are not mandatory to follow. Rather, they are intended to assist CREs to understand and comply with NZ CS. We highly recommend becoming familiar with these documents because they contain useful explanations of what the XRB is expecting to see in climate statements and practical examples of what that could look like, how that could be structured, and the level of detail required.

There are countless ways to report in accordance with the high-level nature of NZ CS, but the XRB's guidance prompts CREs to start thinking about the climate-related risks and opportunities specific to their business, and what information would be material for their primary users – for insurers, these would typically be the policyholders. The guidance is particularly helpful for some of the more challenging aspects of the NZ CS such as scenario analysis, transition planning, and disclosing metrics and targets.

Group climate statements: Focus on the New Zealand business

Understanding your CRD obligations in relation to other related entities is important because this will form the basis of what is reported in your mandatory climate statements. In addition, many will be part of a wider international group which will be preparing to comply with overseas standards aligned with the International Sustainability Standards Board IFRS S1 and S2.

While it may be helpful for New Zealand branches or subsidiaries of overseas insurers to make use of the resources and information made available to them by their overseas parents complying with overseas reporting regimes, NZ CS is paramount. The XRB released a Comparison Document which explains the differences between the NZ CS and IFRS S1 and S2.

Overseas insurers that carry on business in New Zealand (e.g. via a licensed branch) may have obligations under one of the two limbs of s 461ZB in the FMCA:

- If the overseas parent company has a 'large' New Zealand branch: The parent must ensure climate statements are prepared for its New Zealand business as if that business was incorporated in New Zealand; or
- If the overseas parent company has multiple New Zealand subsidiaries (that are together, 'large'): The parent must ensure climate statements are prepared for the group's New Zealand business as if the subsidiaries within that group were incorporated in New Zealand.

What this means for the New Zealand branch or subsidiary of an overseas insurer is that it should be preparing climate statements as if it was its own CRE – but subsidiaries do have the option of combining their climate statements into a single document under s 461ZE.

Good record keeping: Substantiation is key

The primary document to assist insurers with keeping proper climate records is the FMA's guidance for keeping CRD records, which sets out the FMA's principles and expectations for the record keeping requirements. In that guidance, the message is clear: proper climate records will be able to substantiate the content of the CRE's climate statements and also general compliance with the CRD regime.

It is not just about keeping evidence of certain facts or data that are included in climate statements, it is also about keeping records showing the processes the CRE undertook to reach the conclusions or targets it has set out in its climate statements.

The Appendices in the FMA's guidance contain illustrative examples of the records a CRE might keep in relation to each of the four pillars of NZ CS 1. There are examples that are specifically relevant to insurers such as:

- A report presented to the governance body that summarises an analysis of the impact of a recent severe weather event on an insurer and its policy holders;
- Insurance policy that sets out the payouts related to assets that have been destroyed because of a recent wildfire; and
- Workpaper calculating the increase in insurance premiums charged to policy holders due to a reassessment of exposure to climate-related risks.

Given there may be a large amount of records required to be kept, it may be useful to have one central digital platform for storing evidence that can be accessible both internally, or externally (upon request in accordance with the FMC Regulations).

FMA's enforcement approach: Transparency required

There are liabilities and penalties under the CRD regime, split into civil, criminal and infringement offences. However, the FMA in its CRD Monitoring Plan 2023–2026, states that in the first reporting period, the FMA will be taking a 'broadly educative and constructive approach', and supporting development of best practice in the second reporting year.

While the FMA has said it will take an educative approach towards compliance with Part 7A, climate statements are also subject to Part 2 of the FMCA which prohibits false, misleading and deceptive conduct and unsubstantiated representations. And the FMA has made it clear that they are taking greenwashing behaviour seriously, which would give rise to a contravention of Part 2.

To the extent that insurers are struggling with reporting, being transparent about any areas in which you are lacking due to limited resources is key. Avoid making any false promises about climate-related targets or giving misleading information about your entity's progression towards a low-emissions future. Otherwise, you risk breaching Part 2 if you cannot substantiate the content of your climate statements.

A robust due diligence for verification

Directors are required to sign off on their CRE's climate statements. Further, directors are deemed to be liable if the CRE does not prepare, file (and in due course, have assured) the climate statements (s 534). However, s 501 of the FMCA provides a defence for directors if they can prove they took all reasonable steps to ensure compliance with the CRD regime. The defence does not require directors to personally undertake verification of the content in the climate statements, but rather allows directors to reasonably delegate their responsibilities. We unpacked the directors due diligence defence in relation to CRD in our article available here.

"All reasonable steps" looks like an effective due diligence process. A due diligence process should be documented and provide for a robust chain of verification, including governance structures, how evidence is stored, and a post-process review. This process may be aligned with a CRE's existing due diligence processes for financial statements, given Part 7A largely mirrors the financial reporting requirements in Part 7 of the FMCA.

Directors do not need to be climate experts. But they should invest in upskilling themselves and their teams, and engage external experts where required, to ensure that those involved in producing the CRE's climate statements have the right level of knowledge, expertise and information.

Cyber resilience:

Regulators take an interest

Authored by Andrew Horne, Partner and Joy Guo, Senior Solicitor

In March this year, New Zealand experienced its largest cyber data breach to date, when a cyber-attack on Latitude Financial resulted in the theft of 7.9 million customers' data in New Zealand and Australia including details of drivers' licenses, passports and financial information.

The breach is believed to have affected around 20% of the New Zealand population. As a result, Latitude Financial is now the subject of a joint investigation by the New Zealand Office of the Privacy Commissioner and the Office of the Australian Information Commissioner as well as a potential class action on behalf of affected customers.

The Latitude Financial attack follows in the wake of other recent high-profile cyber-attacks in Australia. A cyber-attack on Optus in September 2022 led to the release of personal information of over 10,000 customers. Of particular interest to insurers, a cyber-attack on major life and health insurer Medibank in October 2022 is reported as having led to the release of personal information of 9.7 million current and former customers. Both companies are now subject to consumer and/or shareholder class action claims.

The Financial Markets Authority (FMA) and the Reserve Bank have both identified cyber risk as one of the key threats to the New Zealand financial system and financial institutions' customers. Unsurprisingly, they are taking a close interest in what regulated firms are doing to protect themselves and their customers and communicating their expectations. Increasingly, it appears that financial services regulators will be inquiring into firms' capabilities to prevent and defeat cyber-attacks.

> "The Financial Markets Authority (FMA) and the Reserve Bank have both identified cyber risk as one of the key threats to the New Zealand financial system and financial institutions' customers"

Regulation on business continuity and cyber resilience

The Reserve Bank and the FMA, which are insurers' primary regulators, have been increasingly focusing on cyber resilience following the FMA's thematic review of the cyber resilience of FMA-regulated operators in 2019.

In November 2020, the FMA introduced new standard conditions for fully licensed financial advice providers (FAPs) as part of the change in the financial advice regime under the Financial Services Legislation Amendment Act 2019, which came into force on 15 March 2021. Standard 5 focuses on business continuity and technology systems. For many small or medium sized financial advice providers, these conditions imposed their first compliance obligations for cyber security. The FMA subsequently released a cyber resilience information sheet in July 2021 targeted at small and medium sized FAPs – see our article on the information sheet here.

The Financial Markets (Conduct of Institutions) Amendment Act 2022 (CoFI Act) comes into force in March 2025, by which time all registered banks, licensed insurers and licensed non-bank deposit takers in the business of providing one or more relevant services (Financial Institutions) must have a financial institution licence. In July 2022, the FMA consulted on and finalised six standard conditions for Financial Institutions. Like the standard conditions for FAPs, Standard 5 focuses on business continuity and technology systems. It requires licensees to maintain a business continuity plan and the operational resilience of technology systems if their disruption would materially affect the provision of services or other licensee obligations. Licensees' business continuity plan and technology systems must comply with their fair conduct programme. In addition, licensees must also notify the FMA as soon as possible and no later than 72 hours after discovering any event that materially impacts the operational resilience of their critical technology systems.

In July of this year, the Reserve Bank and the FMA issued new standards and accompanying guidance for designated Financial Market Infrastructures (FMIs) under section 31 of the Financial Market Infrastructures Act 2021. FMIs are multilateral systems that enable electronic payments and financial market transactions. The standards, which will come into effect from 1 March 2024, cover a range of areas, including cyber resilience. Our article on the standards can be accessed here.

The standard conditions and guidance on cyber resilience applying to FMIs are more detailed and onerous than the standard conditions applying to FAPs and Financial Institutions, which focus on business continuity planning and maintaining the operational resilience of technology systems. However, we think it likely that the more detailed standards and guidance applying to FMIs will in time be imposed upon other regulated financial services providers, such as insurers and insurance brokers. The regulators' expectations of FMIs in relation to cyber resilience will therefore be of interest to insurers and brokers.

Standard 17C imposes key obligations upon FMIs on cyber resilience. It requires designated operators to maintain cyber resilience in a manner commensurate with their exposure to cyber risk, and aims to promote cyber resilience by setting expectations and raising awareness of good practice at the board and senior management level.

The standard applies to every operator of a designated FMI that was specified in its designation notice under section 29(2)(f) of the Financial Market Infrastructures Act 2021 as falling within one or more of the following classes of designated FMIs:

- a pure payment system;
- a central securities depository;
- a securities settlement system; or
- a central counterparty.

In summary, Standard 17C requires the following:

- FMIs must have a cyber resilience strategy and cyber resilience framework that is comprehensive, adequate and credible. The strategy and framework must, amongst other things, be based on internationally and nationally recognised frameworks and guidelines, and be reviewed annually and updated when required.
- Importantly, FMIs must ensure that their boards of directors are ultimately responsible for the FMI's cyber resilience, and must take reasonable steps to ensure that their boards understand the relevant cyber risk environment. This means that FMIs should ensure that their directors take steps such as appointing a senior manager with the appropriate skills, knowledge, and experience to be accountable for the cyber resilience strategy and cyber resilience framework. The guidance on Standard 2 (on Governance) makes it clear that boards of directors of FMIs are viewed as ultimately responsible for managing their risks and for establishing and overseeing internal systems (including controls) and audits. While this does not appear to impose additional legal obligations upon directors personally, it suggests that there is a risk that in the event of a major cyber breach, regulators may consider whether directors may have breached their existing duties by failing to take the necessary steps to prevent a cyber resilience failure.
- FMIs must ensure that their cyber resilience strategy and framework, and compliance with them, are assessed by an external qualified auditor in accordance with applicable auditing and assurance standards at least:
  - every two years; and
  - whenever a cyber incident occurs that materially impacts, or could materially impact, the FMI's continuing operations (unless it is not reasonably practicable to do so, in which case the operator must provide its reasons to the regulator as soon as possible).
- The operator must provide any report from an external assurance engagement to the regulator upon request.

The accompanying guidance to the standards is intended to assist operators meet the requirements of the FMI Standards. While not legally binding, it provides guidance on how the FMA and Reserve Bank expect operators to consider and apply the obligations imposed by the standards by drawing on international and national cyber security standards and guidelines. The guidance covers the following, amongst other topics:

- What a cyber resilience strategy and framework should set out and the areas entities should focus on when implementing the strategy and framework.
- Protective measures that should be put in place, such as security controls, monitoring and controlled access to systems and information.
- Detection measures that should be put in place, such as establishing early warning signs and documentation of the normal baseline performance for essential services and supporting systems.
- What response and recovery plans should incorporate.
- What an external assurance assessment should include.
- Board of directors and senior management responsibilities.
- Engaging with third-party providers including the use of contracts to capture cyber security considerations, ongoing cyber risk management and relationship management.

These are detailed guidelines – the regulators' expectation is that entities will have a specific and comprehensive strategy that is verifiable.

New standard condition for market service licence holders

In a continuation of the roll-out of standard conditions addressing business continuity and technology systems, in July this year, the FMA proposed to introduce a new standard condition for the following financial market service licences granted under Part 6 of the Financial Markets Conduct Act 2013 (FMC Act):

- Managers of registered schemes (but not restricted schemes);
- Providers of discretionary investment management services;
- Derivatives issuers; and
- Prescribed intermediary services (peer-to-peer lending providers and crowdfunding service providers).

The proposed business continuity and technology systems standard condition is similar to the ones applying to FAPs and Financial Institutions. The FMA sought feedback on the proposed new standard condition, which concluded on 1 September 2023. We expect a decision to be released in the near future. See the consultation document here, and our article on this here.

Market services licensees should also take account of an information sheet the FMA released in June 2022 to assist all market services licensees under Part 6 of the FMC Act (excluding benchmark administrators) to enhance the resilience of their cyber and operational systems. The information sheet identifies that the FMA expects licensees to have adequate technology architecture, cyber security systems, processes and controls in place to ensure their technology risks are being managed. This includes an expectation that systems, processes and controls are tested and assessed on a regular basis. In addition, licensees should be aware of the risks that potentially impact their organisation. This means understanding their own capabilities, as well as supply chain risks and the operational resilience of third-party vendors. Entities should also have appropriate governance, training, incident response management, reporting and remediation structures in place. Where entities hold both a FAP and another FMC Act Part 6 licence, the information sheets applying to both can be read together.

Additionally, all licensed entities (excluding financial advice providers), including licensed insurers, must meet the minimum standard for operational infrastructure as outlined in the licensing guide for each licence type.

What these changes mean for financial entities and insurers

The regulatory focus on cyber security reflects the increasing risks facing the financial services sector generally, which relies heavily on technology. Consistent with previous years, the 2023 Q1 and Q2 CERT NZ Data Landscape reports show that the highest number of reported cyber security incidents were from the finance and insurance services sector. In addition to reputational damage, losses from cybercrimes can be significant and includes loss and damage (from disruption in operations), liability to customers and third parties (whose data may be released or misused), and regulatory action and fines.

The cyber threat landscape is evolving and is increasingly sophisticated. The regulators will expect insurers and brokers, like other financial institutions, to invest appropriately in measures to protect against and recover from the impact of cyber incidents. Licensed insurers will need to continue with preparations for the CoFI regime to ensure they meet their obligations, including obligations relating to business continuity planning and technology resilience.

Latest cyber security resources and guidance

Insurers should also keep on top of the latest resources and guidance on cyber security.

They may self-evaluate their cyber resilience against the US National Institute of Standards and Technology Cybersecurity Framework. The FMA's cyber security and BCP self-assessment tool for FAPs is another helpful resource. See also the Reserve Bank's Guidance on cyber resilience, CERT NZ Critical Controls 2022 and the cyber risk practice guide from the Institute of Directors New Zealand to help boards understand and approach cybersecurity in their organisations.

The FMA also recommends regulated entities subscribe to CERT NZ Alerts. Refer to our latest podcast on other standards and frameworks available on cyber security and information security.

Managing challenging claims

Authored by Nick Frith, Partner

The Insurance and Financial Services Ombudsman (IFSO) is the insurance sector's main external dispute resolution service. IFSO handles around double the complaint enquiries of Financial Services Complaints Ltd, its main competitor in the financial services external dispute resolution scheme market.

In its 2023 Annual Report, IFSO reported a dramatic 45% increase in both complaint enquiries and complaints in the previous year, compared to 2022. The majority of that increase resulted from the Auckland floods and Cyclone Gabrielle, which had an enormous impact on insureds across the North Island.

IFSO put it this way:

The most common reasons consumers gave for contacting us were delays and customer service issues – not only about the weather event claims, but also business as usual insurance claims. Added to that, we have been contacted by many customers of Latitude Financial Services, following a debilitating cyber attack on their business.

We all hope that 2023 was an aberration given the extreme weather events. However, we think it likely that IFSO is going to remain busy and see an uptick in complaint enquiries over its historic average. As a general rule, complaints increase as people come under financial stress, which may well be the case in coming years given the state of the economy.

Another significant reason for the likely increase in claims is a recent change to IFSO's terms of reference to increase its jurisdiction to $350,000. That aligns IFSO's jurisdiction with that of FSCL and the District Court. This additional headroom gives IFSO the flexibility to deal with more substantial claims.

While IFSO is not bound by the legal rules of evidence or prior precedent, its published decision summaries show that it makes broadly understandable determinations. More importantly, it appears that IFSO provides sufficient assurance to complainants at the first point of enquiry that less than 1% of enquiries turn into formal complaints. In the 2023 reporting years, IFSO resolved 309 out of 327 formal complaints.

The added benefit, particularly when dealing with difficult claims, is that IFSO provides an independent ear for complainants. Many complainants have remarked positively on this aspect of the process. It stands to reason that IFSO's involvement is likely to result in reduced complaints being progressed.

No doubt picking up on the above benefits, IFSO has collaborated with Massey University to develop a short course in Complaint Response and Management. The purpose of the course is to better equip recipients of complaints within businesses to respond and resolve those complaints without escalation. That can only be of benefit to participants.

We see only upside for insurance industry participants in the above developments. They ought to reduce the number of escalated complaints and promote happier customers.

Case study

New guidance on Warranty and Indemnity (W&I) insurance claims

Finsbury Food Group v Axis

Authored by Amber Kim, Solicitor

The English High Court has issued a rare decision in relation to warranty and indemnity (W&I) insurance, providing clarification of the scope of coverage under a buyer-side W&I policy.

In *Finsbury Food Group v Axis & Ors*, the buyer who was the policyholder made a claim for breach of warranty, asserting that recipe changes and price reductions had affected the profitability of a gluten-free baked goods business. In rejecting the policyholder's claim, the High Court provided helpful guidance on when there has been a "*material adverse change*" in a business' trading position for the purposes of vendor warranties The decision also reinforces the following important principles:

- Actual knowledge of any changes to the business prior to completing the purchase will preclude indemnity.
- The importance of establishing how any claimed breaches of warranty caused loss when making a claim under a W&I policy.

Background

Finsbury Food Group Plc purchased a specialist manufacturer of gluten-free baked goods, Ultrapharm Limited for £20 million. Finsbury took out a buyer-side W&I policy that insured Finsbury against losses arising out of any breaches of warranties by Ultrapharm.

Finsbury subsequently made a claim under the policy, alleging that Ultrapharm had made undisclosed recipe changes to two of its products and had also agreed price reductions for them with Marks and Spencer plc, its largest customer. Finsbury said that these breached Ultrapharm's warranties that:

- there had been no material adverse change in trading position of Ultrapharm since 31 December 2017 – (a Trading Conditions warranty); and
- following the Accounts Date, there were no price reductions or discounts that would reasonably be expected to materially affect Ultrapharm's profitability (a Price Reduction warranty).

The insurers declined Finsbury's claim on the basis that it was contrived.

Decision

Trading conditions warranty

The Court held that there was no breach of the Trading Conditions warranty for three key reasons:

- First, the Recipe Change was agreed and came into effect before the Accounts Date. It was agreed in June 2017, and there was evidence that manufacturing of the Recipe Changes took place in December 2017. There had accordingly been no change "*since 31 December 2017*".
- Secondly, the Recipe Change was not a "*material adverse change*" for the purposes of the Trading Conditions warranty. While material adverse change does not have a fixed meaning, the Court considered that it means something that was "*substantial or significant as opposed to something of a de minimis level*". The insurers sought to argue that a material adverse change required a loss of more than 20% of total sales, drawings on a threshold provided for in another warranty. The Court rejected this, noting that the Trading Conditions warranty was a separate warranty with separate criteria.

  In the circumstances of this case, the Court considered that a change of 10% to total group sales since the Accounts Date would constitute a material adverse change.
- Finally, the Recipe Changes were made in the ordinary course of business and did not fall within the ambit of the Trading Conditions warranty. The evidence indicated that it was not unusual for M&S to ask Ultrapharm to develop its recipes, with there having been seven recipe changes since 2013. Accordingly, such changes "*are not, without more…material adverse changes*".

Price reduction warranty

The Court also held that there had been no breach of the Price Reduction warranty. The Price Reduction warranty only covered price reductions agreed after the Accounts Date. The Price Reductions had been agreed in October 2017, before the Accounts Date.

The Court commented that the Price Reduction warranty was not intended to protect the buyer against price reductions that were yet to come into effect or remove the need to undertake the necessary due diligence, noting that, "*...it is to be assumed that Finsbury, as purchasers, will have carried out all necessary due diligence prior to the Accounts Date... The SPA is not intended to be a panacea to resolve any unforeseen consequences of Finsbury's admittedly light touch approach to due diligence*".

Actual knowledge

While there had been no breach of warranty, the Court considered whether an exception clause in the sale and purchase agreement would operate to prevent cover in any event. That clause provided that Ultrapharm would not be liable for a breach of warranty if Finsbury had actual knowledge of the circumstances giving rise to a warranty claim and was actually aware that such circumstances would be reasonably likely to give rise to a warranty claim.

The insurers had the burden of proving actual knowledge on the part of Finsbury. They argued that if the business director at Finsbury had all the facts available to him, Finsbury could not claim that he did not have actual knowledge. Otherwise, it would lead to a "*commercially nonsensical position*" where Finsbury could say that it had no "*actual knowledge*" when Ultrapharm had provided relevant information by email but Finsbury chose to ignore the email or to not open it before completion.

On the evidence, the Court found that the business director had relevant actual knowledge, and was aware that his knowledge would be fatal to the claim under the Policy.

Causation

The Court also considered whether causation could be established in the event of a breach, concluding that Finsbury would have proceeded with the deal at the purchase price of £20 million in any event. The evidence indicated that Ultrapharm was particularly unwilling to sell, and despite knowledge of deteriorating profits at Ultrapharm, Finsbury did not reduce its offer. Finsbury was not concerned with the financial merit of the transaction; rather, it was "*determined to acquire Ultrapharm's recipes and production knowhow*". Therefore, even if breach could be proved, Finsbury would not be able to show that it suffered any loss.

Key takeaways

Finsbury serves as a useful reminder that:

- A claim under a W&I policy requires proof of breach of warranty of the underlying SPA. Courts are unlikely to find a breach where any change to the business were made during the negotiation and before the sale and purchase agreement and the facts were available to the purchaser, but the purchaser failed to undertake all necessary due diligence.
- The case also highlights the importance of defining "*material adverse change*" in the context of an insured warranty. If not defined, its meaning will turn on the facts of each individual case and will be uncertain. Even other terms of the relevant contract providing for certain thresholds in other respects may not influence the interpretation of the material adverse change clause.
- Insurers can and will make use of knowledge exclusions. The courts will consider the facts available at the time, and the policyholder cannot rely on wilful blindness to avoid the consequences of those facts.
- Even if there had been a breach of warranty, the policyholder will need to establish causation. Finsbury illustrates that there will be no claim if the purchaser would have proceeded with the deal for the same price regardless of the changes or differences that are complained of.

Case study

The "but for" test is rejected again

London International Exhibition Centre Plc v Royal & Sun Alliance Insurance Plc [2023] EWHC 1481

Authored by Olivia de Pont, Senior Associate and Hasaan Malik, Law Clerk

In this article, we consider the English High Court's recent decision in *London International Exhibition Centre Plc v Royal & Sun Alliance Insurance Plc & Ors* [2023] EWHC 1481 (Comm), which rejected "but for" causation for the purposes of determining whether cover was available under "at the premises" (ATP) clauses in Business Interruption (BI) policies.

This decision concerned six test cases, each involving policyholders who had made BI claims following the closure of their businesses as part of the response to the COVID-19 pandemic. It is an interesting and important follow-on from the UK Supreme Court's landmark decision in the BI "test case" of *Financial Conduct Authority v Arch Insurance (UK) Ltd & Ors*. The FCA test case dealt with similar causation issues in the context of "radius" or "disease" clauses, also rejecting "but for" causation in many cases of loss with concurrent causes. We considered that decision and its implications in Issue 22 of Cover to Cover, which can be found here.

The facts

All of the claimants, most of which were small or medium-sized businesses, were required to close due to the UK Government's response to the COVID-19 pandemic. They all had a form of ATP cover in their BI insurance policies which provided cover for losses from business closures arising as a result of the outbreak or occurrence of a notifiable disease at the insured's premises.

Their insurers declined cover for losses arising from these business closures on the basis that a "but for" causation test applied. The insurers said that ATP clauses envisage a "*direct, conventional, causal connection … between occurrences of the disease at the premises, authority action, and business interruption and loss*". They argued that ATP clauses did not provide cover for losses caused by general and non-specific government action taken in response to spread of a disease across a wider area. Alternatively, the insurers said that it was necessary to consider whether the outbreak of disease at the premises was a 'distinct' or 'effective' cause of closure, such that occurrence at the premises (not more broadly) caused authorities to order the closure.

Case study:
The "but for" test is rejected again

The decision

The Court rejected the insurers' arguments, holding there was no principled reason why "but for" causation should apply to ATP clauses but not "radius" or "disease" clauses. Accordingly, the High Court applied the Supreme Court's approach in the FCA test case to ATP clauses.

Relying heavily on the Supreme Court's reasoning in the judgment, Justice Jacobs held that:

- The ATP clauses before the High Court were very similar to those considered by the Supreme Court. ATP clauses can be viewed as simply a narrower form of radius clause. Both apply to occurrences of notifiable disease within the specified radius – whether that is within the narrower radius limited only to the insured premises (and therefore "at the premises") or within a wider radius specified by the policy. Naturally, this would necessitate the same approach to causation to be adopted and applied to both clauses.
- The nature of the notifiable diseases covered by both the ATP policies before the High Court and the policies considered by the Supreme Court favoured the application of the Supreme Court's approach. The policies covered the same diseases, many of which are highly contagious and capable of widespread dissemination. The Supreme Court's findings – that the nature of the diseases covered had potential to call for a response that is not solely responsive to cases within the specified area and that one would expect cases of the disease to combine and cause loss – were equally applicable to ATP clauses.
- "At the premises" is simply a way to limit the geographical or territorial scope of the coverage provided. It does not impact the approach to causation.
- There was nothing in the wording of the clauses in this case and before the Supreme Court that restricted cover to situations where losses were caused solely by the occurrence of the disease within the specified area. They only required that the occurrence is a proximate cause of loss. Additionally, the policies did not exclude cover in respect of occurrences outside the specified area.
- The Supreme Court's approach had the added benefit of being clear and simple to apply. The approaches suggested by the insurers were unclear and would be difficult to apply in practice.

What does this mean for insurers?

The Court's rejection of the "but for" causation test proposed by the insurers clarifies that the courts will not take a strict approach to causation in cases such as this. It will have ramifications for insurers' responses to BI claims generally, not only in relation to COVID-19 issues. The decision indicates that insurers cannot apply a simple "but for" test to reject claims on the basis that the insured would have suffered loss regardless of the insured peril.

The future of insurance cover for weather-related natural disasters

Authored by Olivia de Pont, Senior Associate and Charlotte Wong, Solicitor

The Insurance Council of New Zealand's latest reporting on the Auckland Anniversary weekend floods and Cyclone Gabrielle describes the extent of the losses suffered. As of 1 September 2023, insurers had paid out $2.053 billion on these claims, which is expected to increase to $3.5 billion once all claims are settled. This is very significant – it represents the vast majority of insured losses recorded in the Asia-Pacific Region for the first half of 2023.

These events were very destructive, and it seems that the risk of similar events may be increasing. Between 1909 and 2016, New Zealand's recorded average atmospheric temperature increased by 1.1°C. Continued warming is expected to result in heavier and more concentrated rainfall. It will also increase the frequency and severity of 'atmospheric rivers' (plumes of water vapour that travel here from the tropics and turn into rain) and cyclones. Moreover, with sea levels predicted to rise at least 10cm by 2040 and some models predicting greater increases, together with subsidence in land, coastal flooding and damage from storm surges is expected to become more common. This will be an issue particularly in areas with a number of low-lying properties such as Dunedin, Napier, Tauranga and Wellington, where even a minor storm surge can reach properties above the high-tide line. Frequent extreme weather events are not just a future problem; they are also a present reality. Prior to the twin disasters earlier this year, the Insurance Council of New Zealand reported that the total amount paid out by insurers for weather-related claims in 2022 had reached a record-breaking $335.58 million. For the months of July to August 2022 alone, $123.8 million

for weather-related claims had been paid out. This exceeded the provisional estimates for such claims by 35%.

Insurers' likely response: Partial or full retreat from the market?

While it remains to be seen how insurers will respond to the increased frequency of these claims, it is expected that many homeowners will experience a partial retreat by insurers from the home insurance natural disaster market, which may later be followed by a full retreat. A partial retreat would see insurers introducing terms that shift some risks back on to the insured. Examples include caps on coverage, hazard exclusions and hazard-specific excesses. A full retreat would see insurers refusing to insure properties for natural disaster risks at all because they are deemed to be too high risk.

A partial retreat from the home insurance market occurred following the Canterbury earthquakes. Many insurers replaced uncapped obligations to pay for reinstatement of insured property up to a particular floor area with a promise to pay for reinstatement up to a specified sum insured. This limited insurers' exposure to unexpected cost increases where natural disasters affected a particular region. Those risks have been shifted to insureds, who are arguably better placed to obtain estimates for the cost of repairing or replacing their own properties in any event.

Similarly, for properties at increasing risk of coastal flooding, it is expected that homeowners will experience a gradual insurance retreat. In the short term, insurance may still be available for excessive rainfall, but storm surges, for example, may be excluded. This may lead to disputes over liability where multiple hazards coincide, such as where rainfall cannot drain due to an earlier storm surge. In four major New Zealand cities (Auckland, Wellington, Christchurch and Dunedin), around 10,230 properties are expected to have experienced a full insurance retreat for flood risks by 2050. Wellington and Christchurch are expected to have done so by the early 2040s, with Dunedin and Auckland following in the late 2040s. Once a full retreat has occurred, prospective purchasers may struggle to obtain mortgages without insurance and existing mortgagors may find themselves in default given their mortgage agreements require them to maintain insurance.

Accompanying a retreat from the home insurance market for natural disaster risks will likely be a significant increase in premiums for at-risk properties. Home insurance premiums rose by an average of 21.2% between the September 2022 and 2023 quarters. Should home insurance become unaffordable, there may be pressure for Government intervention, which has happened in the United Kingdom and in parts of the United States for risks that private insurers have come to regard as unaffordable in certain areas, such as flood and wildfire.

Government intervention?

In the United Kingdom, the increasing unavailability of affordable home insurance for flood risks has been addressed through a Government reinsurance scheme, Flood Re. Established by the Water Act 2014 (UK), Flood Re's purpose is both to ensure the availability of affordable home insurance for flood risks and to facilitate a transition to risk-reflective pricing by insurers by 2039, at which point the scheme will be disestablished. Flood Re is funded by charging insurers premiums and excesses when they pass a flood risk to the scheme and also by an annual levy on insurers which generates about £135 million per year. A key part of the scheme is Build Back Better, which allows for payouts to owners of flood-damaged homes that not only cover the cost of repairs, but also the cost (up to £10,000) of identifying and implementing flood mitigation measures. Whether a policy offers Build Back Better and the threshold at which it becomes available depends on the individual insurer.

The Flood Re scheme is understood to be operating successfully, with 99% of residential properties at high risk of flooding able to obtain quotes from at least 15 insurers.

Similarly, in some American states, including California, Florida and Texas, Fair Access to Insurance Requirements or "FAIR" plans offer limited "insurance of last resort" for residential properties that insurers have declined to insure because they are at a high risk of experiencing severe weather events. Whilst the eligibility requirements differ from state to state, commonly homeowners must show that their property has appropriate risk mitigation measures in place and that at least two insurers have refused to insure it. FAIR plans tend to be funded by premiums rather than the state. If these premiums cannot cover all claims lodged, the FAIR plan administrator may issue assessments requiring either insurers or insureds (depending on the state's set up) to pay for the outstanding claims. FAIR Plan payouts are often calculated on an actual cash value rather than a replacement cost value, therefore, it is unlikely that a payout will enable a flood resistant rebuild like under Flood Re's Build Back Better policy.

New Zealand already has a layer of government-backed natural disaster insurance in the form of Toka Tū Ake EQC. Under the Earthquake Commission Act 1993, EQC provides limited state-funded natural disaster insurance known as "EQCover" for residential buildings and residential land up to a maximum of $300,000 plus GST. This is an increase from the previous maximum of $150,000 plus GST.

In 2015, Treasury released a discussion document that drew on learnings from the Canterbury earthquakes to propose changes to the EQC Act. The document identified three areas for improvement. First, the dual insurance model (whereby EQC and insurers jointly contribute to insurance obligations for residential properties) had operated in a way that was unnecessarily costly, confusing and complex. Second, EQC faced institutional challenges, being a small institution that had to adapt quickly in the face of large-scale disasters. Third, the EQC scheme required clarification given there had been inconsistencies in interpretation.

The discussion document favoured EQC's premium is remaining at a flat rate for the foreseeable future. Risk-differentiated EQC premiums were thought to be incompatible with scheme's goal of achieving near-complete cover across the country, as homeowners in high-risk areas would be more likely to opt out. Furthermore, it was expected that there would be a sense of unfairness if a disaster occurred in a low-risk (and therefore low premium) area and large payouts were made. The Treasury was also not convinced that disaster modelling has reached the stage where risks could be identified with sufficient certainty to enable fair risk-differentiation. One significant gap in EQCover is it does not cover flood damage to residential buildings, though flood damage to residential land itself is covered. The document suggested that this should remain the case.

Building on the discussion document, the Natural Hazards Insurance Act was passed earlier this year and will come into force in July 2024, replacing the EQC Act. While a full breakdown of the changes the NHI Act introduces is outside the scope of this article, broadly speaking, the scope of cover is similar to that under the EQC Act.

Retreat and relocation

After the two major flooding events earlier this year, some homes in Auckland were assessed as being in risk category 3, meaning they cannot be rebuilt as the property is considered unsafe to live in due to an unacceptable risk of loss of life in future flooding. In October 2023, Auckland Council accepted a proposal to buy out 700 category 3 homes for $774 million. The Council will buy out insured homes for 95% of their value and uninsured homes for at least 80% of theirs. The Hawke's Bay District Council and Napier City Council have a similar buy-out programme in place for category 3 homes, with funding split equally between the Government and the Councils. While such buy outs prevent costs caused by future disasters, they are not a perfect solution. Auckland homeowners are anxious that these buy outs will leave them unable to pay off their mortgages, let alone afford similar properties. On the other hand, the Buller Regional Council, as one of the poorest councils in the country, does not have the means to buy out every high-risk homeowner, so this solution is off the table in the absence of Government intervention.

While mitigation is helpful, it is unlikely to be a lasting solution for high-risk areas. For example, the Hawke's Bay area has experienced weather events causing severe flooding many times in the past century such as in March 1924, April 1938, March 1988 (Cyclone Bola) and October 2004. Mitigation measures built to withstand (previously) once in 20-year flooding events are not going to be able to weather (previously) once in 100-year events, which are expected to become increasingly common. Moreover, measures that divert flooding from one area often cause greater flooding in another.

Conclusion

The answer to the challenges presented by increased risks of weather-related natural disasters and damage events is likely to be a combination of the three options described above. The insurance industry is likely to drive change in the first instance by identifying property as uninsurable. The nature and extent of any Government response to that will be an important factor in how much impact it has on the general population and investment in at-risk property. A Government response may provide a long-term solution for at-risk property other than coastal property, where increasing risk from sea level rise appears to be inevitable, so that an insurance-led response can only be temporary.

In the longer term, it is likely that councils will cease issuing consents for developments in high-risk locations and start moving people away from them. In low-lying South Dunedin, for instance, the Dunedin City Council is considering facilitating a managed retreat from land upon which around 12,000 people currently reside and converting that land back into wetlands. The plan would take four years to implement and cost close to $4 million. While relocation may be costly in the short-term, in some instances it appears to be inevitable, and requires a societal response rather than an insurance solution.

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