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THE MEASURE OF INDEMNITY UNDER PROPERTY INSURANCES

The Court of Appeal in *Endurance Corporate Capital Ltd v Sartex Quilts & Textiles Ltd* [2020] EWCA Civ 308, [2020] WLR(D) 143 has provided much needed clarification on the calculation of the sum recoverable under an insurance policy on property following loss or damage to the insured subject matter. Two issues in particular have given rise to much debate: is the assured entitled to recover repair costs when no repairs have taken place by the date of the trial; and is the assured required – by way of betterment – to account for improvements effected in the property at the expense of insurers? The Court of Appeal's approach was to assimilate insurance with other claims for breach of contract and to apply the latter's general principles to the former.

It is open to insurers to address the measure of indemnity by express policy terms. Some buildings insurances are written on the basis that the assured is to receive an amount representing diminution in market value before and after the occurrence of an insured peril ("indemnity"), with the option to pay an additional premium for a higher sum representing repair costs ("indemnity plus"). Others may confer upon the insurers the right to decide whether the assured is to receive market value or repair costs, although if the assured opts for the latter it is generally required that insurers will pay only for costs actually incurred and that the work is commenced with reasonable dispatch. Policies on goods, and particularly domestic goods, are frequently written on a "new for old" basis so that the assured receives a new product irrespective of the condition of the old product, and buildings insurances may similarly specify a standard taking in improvements ("as new" as opposed to "when new" – see *Bruce v IAG New Zealand Ltd* [2019] NZCA 590) or actually stating that higher requirements imposed by modern building regulations form part of the indemnity.

The policy in *Sartex* was on manufacturing works in Rochdale. The works were seriously damaged by fire on 25 May 2011. The premises were uninsured, and in 2015 Sartex commenced proceedings against its brokers for negligence in their assessment of the level of insurance required. Sartex recovered £1,000,000 from the brokers. The present claim was one against the insurers for the actual sum insured by the policy. By the time of the trial, repair work had not been commenced. The policy contained express provisions on the measure of indemnity and betterment, although they were of limited assistance. The obligation of the insurers was to "indemnify …. against loss or destruction or damage to Property". The basis of indemnity was "the Reinstatement of the Property lost, destroyed or damaged". However, the insurers' liability for repair costs was limited by a Special Condition requiring the commencement of reinstatement without unreasonable delay and costs actually being incurred: if either provision was not fulfilled, the sum recoverable was "the amount which would have been payable in the absence of this condition." In the present case the Special Condition precluded recovery for repair costs, so Sartex was thrown back on the general insuring wording providing "[indemnity …. against loss or destruction or damage to Property."

The initial question was whether Sartex was entitled to diminution in market value or repair costs. The key factual finding in the first instance decision of David Railton QC (now Railton J) was that Sartex had at the date of the fire intended to continue to use the works in its manufacturing process. The initial question thus became whether Sartex's loss was the value of the buildings at the date of fire (replacement cost) or the value of the buildings at the date of the trial (which, in the absence of repair, could only be diminution in market value).

In addressing that problem, the starting point of Leggatt LJ, giving the sole reasoned judgment in the Court of Appeal, was the principle firmly established in England that an insurance contract is one whereby the insurers undertake to hold the assured harmless from loss, so the obligation to indemnify arises immediately on the occurrence of the insured peril with the consequence that unliquidated damages are payable immediately. This remains capable of raising eyebrows in that it leads to the conclusions that an insurer is in breach of contract as soon as a fire, earthquake or other peril occurs without having actually done anything wrong, and that the limitation period runs from the date of the peril. The Australian courts remain divided on the matter (see the 3:2 decision in favour of the English approach in *Globe Church Incorporated v Allianz Australia Insurance Ltd* [2018] NSWSC 1367). However, in accordance with Leggatt LJ's analysis, the principle provides the basis for determining the measure of damages. Loss, in the form of the value of the property to the assured, must be ascertained at the date of the peril, and how the sum awarded is actually spent is a matter for the assured alone. In short, the assured's post-peril acts or intentions are (express terms aside) irrelevant to the measure of indemnity (see also *Manchikalapati v Zurich Insurance plc* [2019] EWCA Civ 2163, [2020] Lloyd's Rep IR 77).

One recent troublesome authority to the contrary was the comment by Christopher Clarke LJ in *Great Lakes Reinsurance (UK) SE v Western Trading Ltd* [2016] EWCA Civ 1003, [2016] Lloyd's Rep IR 643 to the effect that "I doubt whether a claimant who has no intention of using the insurance money to reinstate, and whose property has increased in value on account of the fire, is entitled to claim the cost of reinstatement as the measure of indemnity unless the policy so provides" (para 72). Leggatt LJ explained that the comment was obiter and that it arose in the unusual context where the property was more or less worthless by reason of planning restrictions prior to the fire, but in a repaired state would have been of substantial value: the comment merely operated to deprive an assured in that position of a windfall.

It follows, therefore, that the focus is on the value of the property to the assured at the date of the peril, and on that basis Sartex – having established an intention at the date of the fire to use the property for its manufacturing business – was entitled to recover rebuilding costs even though there had been no rebuilding at the date of the trial (and, for that matter, might never be). Had Sartex's intention before the fire been to sell the building, the measure of indemnity would have been market value (as in *Leppard v Excess Insurance Co* [1979] 1 WLR 512, [1979] 2 All ER 668).

The focus on value at the date of loss gives rise to a difficulty where the building has unique features and the assured insists upon a reinstatement which includes those features. Earlier authorities had approached the matter by looking at their value to the assured. The measure of indemnity for a building used for purely functional purposes, which could operate equally effectively by rebuilding to modern equivalent standard, was that standard only (*Exchange Theatre Ltd v Iron Trades Mutual Insurance Co* [1983] 1 Lloyd's Rep 674), whereas the owner of a dwelling that had been purchased for such features was entitled to reinstatement to that standard (*Reynolds v Phoenix Assurance Co Ltd* [1978] 2 Lloyd's Rep 440). The clarity brought by the judgment of Leggatt LJ in *Sartex* is the analysis of these cases as an application of the mitigation principle. Any claimant in breach of contract proceedings must act reasonably to be placed in the same position as if the breach had not occurred. An assured mitigates loss of a functional building by replacing it with a modern equivalent. An assured who has lost of a building with aesthetic features mitigates by reinstating only to the extent that a reasonable person in the same position would have so acted. That was the principle to be derived from the House of Lords' decision in *Ruxley Electronics and Construction Ltd v Forsyth* [1995] UKHL 8, [1996] AC 344, where the claimant was entitled to recover only a small amount of damages for loss of amenity when provided with a swimming pool of incorrect depth but functionally of the same value and utility: no reasonable person would have demanded a rebuild in such circumstances. The obvious simplicity of applying ordinary mitigation principles to insurance claims imposes an important objective check on otherwise subjective loss. On the facts there was no mitigation problem: *Sartex* was seeking to recover the reinstatement costs of its existing building, and there was no evidence of a cheaper means of making good the loss, eg, in the form of a new building or a new location.

The final matter addressed by Leggatt LJ in *Sartex* was that of betterment. There is a substantial body of authority to the effect that an insurance claim is to be reduced to the extent that the repairs give the assured an improved building. The origins may be found in the eighteenth-century principle that one-third should be deducted from the value of a wooden vessel on her maiden voyage (codified by s 69 of the Marine Insurance Act 1906 as "customary deductions"). The betterment principle is almost always restated in property insurance cases (notably *Reynolds*) but it is of interest to note that insurers have to date not succeeded in persuading the courts that there is sufficient evidence that deductions should be made. The seeming conundrum here was solved by Leggatt LJ's application of common law mitigation principles, as laid down in his own judgment in *Thai Airways International Public Co Ltd v KI Holdings Co Ltd* [2015] EWHC 1250 (Comm), [2016] 1 All ER (Comm) 675. Three situations were distinguished: (a) where the assured chose to make improvements at extra cost, the sum incurred was not recoverable by reason of betterment; (b) where the rebuilding incidentally and unavoidably resulted in improvements, there was no betterment; and (c) where the assured derived real pecuniary advantage from reinstatement, there was betterment and a deduction was necessary. To illustrate the point: (a) the cost of adding double glazing to a single-glazed building was betterment; (b) the cost of replacing a damaged machine with a new one because a machine equivalent to that owned by the assured could not be found was not betterment; and (c) the cost of replacing a machine with one more efficient conferred pecuniary benefits that could be deducted by way of betterment (the actual decision in *British Westinghouse Electric & Manufacturing Co Ltd v Underground Electric Railways Co of London Ltd* [1912] AC 673). Although the point did not arise in *Sartex*, it is necessary to qualify point (b) with the consideration that a policy indemnifies only for loss caused by an insured peril: if the insured subject matter was, before the occurrence of the peril, in a dilapidated condition or suffering from significant defects, the assured cannot simply argue that the occurrence of some damage entitles reinstatement of the whole: proof of causation is logically anterior to any claim under the policy (see, eg, *He v Earthquake Commission* [2019] NZCA 373, *Emmons v Mitsui Sumitomo Insurance Co Ltd* [2019] NZHC 277).

On the present facts no question of betterment arose. The burden of proving that Sartex would derive real pecuniary advantage from reinstatement was borne by the insurers, and they had not produced anything other than assertion to back up the argument.

Sartex is destined to become the decision of first reference on the measure of indemnity, one that explains the earlier authorities and brings them into an established contractual framework of breach, mitigation and betterment. *Sartex* is, however, just one piece in a very complex puzzle that has been removed from its box by the earthquake sequence in Canterbury, New Zealand, between September 2010 and June 2011. Indemnity disputes under property policies have troubled the English courts on relatively few occasions, but a decade of litigation in New Zealand has highlighted a range of complex questions, exacerbated by old policy wordings and systematic underinsurance. The New Zealand courts have come to much the same conclusion as in *Sartex* on the

measure of indemnity (*Prattley Enterprises Ltd v Vero Insurance New Zealand Ltd* [2016] NZSC 158), but other matters analysed, and yet to reach the English courts, include the following. First, the scope of the right to recover where an insured peril renders property unusable or incapable of occupation without causing physical damaged (*Kraal v The Earthquake Commission* [2014] NZHC 919 – no recovery). Secondly, the measure of indemnity where the policy is capped at notional rebuilding costs but rebuilding is impossible on site due to land damage so that the costs can never be incurred (*Avonside Holdings Ltd v Southern Response Earthquake Services Ltd* [2015] NZSC 110 – matters such as architects' fees and builders' margin to be included). Thirdly, whether the marine concept of constructive total loss applies to a building that is badly damaged and incapable of rebuild other than that a cost greater than the repaired value (Leggatt LJ in *Sartex* suggested that there would be a total loss if there is so little left that demolition and replacement is the most economic option). Fourthly, the number of claims that may be made in a single policy year where a sequence of perils causes losses which have not been repaired in the intervening period (*Moore v IAG New Zealand Ltd* [2019] NZHC 1549, *Mathieson v Tower Insurance Ltd* [2020] NZHC 136 – the overall policy limit for any one year applies); the implications for the indemnity principle where an assured sells a damaged building for full unrepaired value and assigns the insurance claim along with it (*Xu v IAG New Zealand Ltd* [2019] NZSC 68 (*Toomey v IAG New Zealand Ltd* [2019] NZHC 2882 – if the assured has received market value, there is no loss and nothing can be assigned). Finally, and still a pending issue, whether an insurer, having paid for repairs, must make good the repairers' defective workmanship.

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