IN THE HIGH COURT OF NEW ZEALAND
AUCKLAND REGISTRY

CIV 2006-404-6941

BETWEEN	PEGASUS GROUP LIMITED Plaintiff
AND	QBE INSURANCE (INTERNATIONAL) LIMITED First Defendant
AND	AMERICAN HOME ASSURANCE COMPANY Second Defendant

Hearing: 27-30 April 2009, 1 May 2009, 4-8 May 2009, 11-15 May 2009

Appearances: M J Tingey & D J Vizor for Plaintiff
M O Robertson & H M Twomey for First Defendant
A Challis, P Hunt & K Harkess for Second Defendant

Judgment: 1 December 2009 at 3.00 pm

JUDGMENT OF WINKELMANN J

This judgment was delivered by me on 1 December 2009 at 3:00 pm pursuant to Rule 11.5 of the High Court Rules.

Registrar/Deputy Registrar

Bell Gully, Auckland
Shieff Angland, Auckland
McElroys, Auckland

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A. INTRODUCTION

[1] From 2001 to 2005 Pegasus Group Ltd (Pegasus) stored stock at warehouses operated by New Zealand Express Ltd (NZE). Pegasus claims that some of that stock was stolen. It now sues its insurer, the first defendant, QBE Insurance International Ltd (QBE), for the indemnity to which it says it is contractually entitled. Pegasus claims that indemnity covers the value of the stolen goods and the losses it suffered by reason of the disruption to business caused by the thefts. It also claims consequential losses suffered as a result of what it claims to have been QBE's wrongful refusal to meet its claims.

[2] Pegasus advances these claims as causes of action for breach of contract and for breach of the duty of good faith; the latter duty being either contractual or an independent, concurrent obligation in respect of which Pegasus seeks exemplary damages in addition to compensatory damages. Pegasus says that QBE grossly delayed processing its claim, that it resolved to decline the claim before even properly investigating it, and finally that it has defended this litigation using any means available, fair or foul. It says the level of bad faith on QBE's part is worthy of condemnation and justifies an award of exemplary damages.

[3] QBE responds that it has no contractual obligation to indemnify Pegasus because the stock was not stolen and that the apparent stock loss is in reality the result of miscalculation of stock levels, which is explained by defects in the overall stock management system operated between Pegasus and NZE. In effect the defendants say there is no stock loss, there is only inventory error. Any evidence of theft is of petty pilfering, not large scale theft as Pegasus contends. It says that if Pegasus cannot prove theft of its stock, then it can have no claim under its business interruption policy. In any case, it says that the business interruption claim is significantly overstated.

[4] NZE is now in liquidation. Pegasus also sues NZE's insurer, American Home Assurance Company Ltd (AHA) under the provisions of s 9 of the Law Reform Act 1936. That section enables a claimant to receive the benefit of a

company's claim to indemnity from its insurer in some circumstances. AHA also denies that the stock has been stolen, and says that, in any case, there is an exclusion of liability clause that applies.

[5] Finally, both QBE and AHA say that any claim Pegasus has against them must be reduced by the amount of outstanding warehousing charges owed by Pegasus to NZE. Pegasus stopped paying charges when large volumes of its stock could not be located by NZE. QBE also says that it is entitled to set-off any amount that AHA pays Pegasus against any obligation it has to indemnify Pegasus.

[6] In respect of the claims against both defendants it is necessary to determine whether Pegasus has proved that its stock has been stolen, and if so, the quantity of that stock. If Pegasus cannot prove that its stock has been stolen, then all claims it has against the defendants fail.

[7] If that issue is resolved in Pegasus' favour, the following questions arise in respect of each defendant:

QBE:

1. Is Pegasus contractually entitled to indemnity for lost stock, and if so, for what amount?

2. Is Pegasus entitled to make a business interruption claim, and if so, for what amount?

3. What expenses is Pegasus entitled to recover under its contractual indemnity?

4. What consequential losses is Pegasus entitled to recover for breach of the contract of insurance?

5. Did QBE owe Pegasus a duty of good faith under its contract or in addition to its contractual obligations and, if so, is Pegasus entitled to exemplary damages for a breach of that duty?

AHA:

1. Is Pegasus entitled to indemnity for lost stock from AHA, and if so, for what amount?

[8] Finally, in relation to Pegasus' claims against both insurers, issues arise as to whether any claim to indemnity Pegasus has must be reduced by the amount of the self help remedy it has exercised against NZE, by withholding the payment of contractual storage fees. An issue also arises as to whether the claim against QBE should be reduced by any recovery from AHA.

B. FACTUAL BACKGROUND

Policy documentation

QBE policy

[9] Pegasus entered into a number of contracts of insurance with QBE through its broker. The first of relevance to the present claim covers the period 1 September 2003 to 1 September 2004, and the second, the following 12 month period. The cover purchased was comprehensive, dealing with several different types of risk. Policy Section A provided indemnity cover for material damage. The relevant clause for both indemnity periods was 21.1.1 which provides:

> If, during the Period of Insurance, physical loss or damage – unintended or unforeseen by the Insured - happens to any of the Insured Property, then, subject to the terms, conditions and exclusions of this section of this Policy and the General Policy Exclusions and General Policy Conditions and Clauses, the Company will indemnify the Insured for the loss or damage and expenses. The Insured will be indemnified by payment or, at the Company's option, by repair or by replacement of the lost or damaged property.

[10] Exclusions apply to this part of the policy. At issue in this proceeding is the application of clause 21.3.5 which provides:

> This section does not insure unexplained disappearance, loss, or shortages revealed at any stocktaking or shortages due to accounting or clerical errors.

[11] There was also an excess for theft losses; $1,000 in the 2003/2004 indemnity period, and $2,500 in the 2004/2005 indemnity period.

AHA policy

[12] Prior to liquidation NZE had entered into the crime insurance policy with AHA to provide insurance for certain risks including theft. The policy provided that NZE was entitled to indemnity as follows:

> The **Insurer** shall indemnify the **Insured** for their direct financial **Loss** sustained at any time consequent upon a single act or series of related acts of **Theft**, fraud, dishonesty or criminal damage committed by any **Employee** (acting alone or in collusion with others) or **Theft** or criminal damage committed by any other person, which is:-
>
> (i) committed with the clear intent to cause the **Insured** a **Loss**, and
>
> (ii) **Discovered** by the **Insured** during the **Policy Period** or the **Discovery Period**, and
>
> (iii) committed within the **Geographical Limits**, and
>
> (iv) not excluded under the terms and conditions of this policy.
>
> …

[13] The definitions clause, clause 2, contained the following definitions of relevance:

> 2.11 "**Loss**" means the direct financial loss (other than salaries, commissions, fees, bonuses, promotions, awards, profit sharing, pensions or other employee benefits paid by the **Insured**, which are not deemed direct financial loss), sustained by the **Insured** in connection with any single act or series of related, continuous or repeated acts (which shall be treated as a single act) of **Theft**, fraud, dishonesty or criminal damage committed by any **Employee** (acting alone or in collusion with any other **Employee** or others) or of **Theft** or criminal damage committed by any other person, or in which such **Employee** or other person is involved or implicated. **Loss** includes any liability the **Insured** may have to restore or make good **Money**, **Securities**, or other property of another person.
>
> 2.22 "**Theft**" means the unlawful taking, including by violence or threat of violence, of **Money**, **Securities,** or other property to the intended permanent deprivation of the **Insured**.

[14] Significantly, however, since NZE's business involved it storing the property of others, the policy contained a clause that extended cover to the property of third parties which provided:

> Cover is extended to include direct financial **Loss** sustained by any other person or organisation following **Loss** of **Money**, **Security**, or other property under the care, custody or control of the **Insured** or for which the **Insured** is liable.

[15] Like QBE, AHA relies on its inventory exclusion clause. Exclusion 4.9 provides that AHA is not liable for:

> **Loss**, the proof of which is dependent solely upon a:
>
> (a) profit and loss computation or comparison; or
>
> (b) comparison of inventory records with an actual physical count.
>
> However, where an **Employee** is involved in suspected of causing **Loss** and has been identified, inventory records and actual physical count of inventory can be submitted as partial evidence in support of proof of **Loss**.

Provision of warehouse services by NZE

[16] Pegasus is an importer and distributor of branded sporting and leisure goods. These are predominantly high volume, low value goods such as lunch boxes, drink bottles and, towards the higher end of the value range, bikes branded with fictional characters. Its stock also includes sporting goods such as branded rugby and basketballs, and golf club sets. It designs a significant proportion of its goods and has them manufactured overseas. Those goods are then imported into New Zealand and stored. Pegasus began storing its product at the NZE Mono Place warehouse in Ellerslie in 2001. From about September 2004, its stock was stored at NZE's warehouse in Donner Place, Mt Wellington.

[17] Pegasus labels each of its products with a product code, usually a bar code applied at the time of purchase. If new product is ordered, new codes are issued. If repeat product is ordered then existing codes are reused. The same product, when supplied to different retailers, may have different codes. This arises because some retailers stipulate that product should be supplied to them with their pricing bar codes already affixed.

[18] The sole director and shareholder of Pegasus, Mr Kerrin Harrison gave evidence at trial as to how the stock and stock records of Pegasus were managed by NZE and Pegasus, including the processes used between Pegasus and NZE for taking, reconciling and recording the results of manual stock counts. Mr Harrison was the only witness of fact called to give evidence on the management of Pegasus' stock records. He said that the process operating for storage of Pegasus goods by NZE was as follows: NZE would take delivery of Pegasus' stock direct from Pegasus' suppliers. NZE was provided with a copy of the purchase order, and checked the deliveries it received against those purchase orders. It then notified Pegasus of goods received. Pegasus also tracked inwards goods through shipping schedules and payments. By these means it attempted to ensure that any discrepancies between goods ordered, shipped, delivered and received would be found at the time of the inwards goods, and would be discussed with NZE and resolved. Goods purchased by Pegasus were not entered into Pegasus' perpetual stock records (run with a software package called Prophet) until they had been received by NZE and any discrepancy between the amount received and the order and shipping documentation resolved, thereby ensuring the accuracy of Pegasus' stock records at this point. The goods would then also be entered into NZE's records.

[19] Goods were shipped direct from NZE to Pegasus' customers. Pegasus would key the orders it received from customers into its Prophet system, export that information from Prophet as an electronic file and then send the information by email to NZE. NZE would import the electronic file into its stock system and produce the picking slips for the stock. Orders were then picked and packed by NZE staff and delivered to customers by a third party trucking company. On occasion Mr Harrison visited NZE and viewed its picking and packing process.

[20] NZE supplied Pegasus with a daily list of product sent to Pegasus' customers. Pegasus marked the order as complete in its Prophet system, and generated an invoice for the customer. Stock levels recorded at both NZE and Pegasus were reduced by the amount of that order. If any customer did not receive the amount ordered or invoiced for, Mr Harrison said the customer would raise it with Pegasus and the issue would be taken up with NZE. That rarely happened before July 2004.

Reconciliation of NZE and Pegasus systems

[21] Each month NZE would send Pegasus a list of the stock recorded in NZE's system, and each month Pegasus would match that list by product code to its own records and identify any discrepancies.

[22] Mr Harrison's evidence was that any discrepancies found were researched and usually resolved by the time of the following month's reconciliation. Unresolved discrepancies, positive or negative, were recorded in an account receivable entitled "NZE". NZE would be invoiced for any negative variances. Common causes of discrepancies identified were inwards goods not entered or purchase orders not made complete. These were usually a matter of human error, including delay in inputting data. Occasionally discrepancies would arise because of timing differences between NZE's and Pegasus' month end. Month end reconciliations up until June 2004 were produced into evidence. The extent to which these month end reconciliations took place after June 2004 is subject to challenge by QBE and AHA.

Reconciliation of Pegasus system to stocktake results

[23] NZE also carried out a physical stocktake every six to 12 months using product codes. When completed, NZE would supply Pegasus with a copy of the inventory and then balance its stock system. Pegasus then produced an exception report by product code identifying where the quantity revealed by the physical count did not correspond to the quantity shown as available for sale in Pegasus' inventory system. The recent history of each stock code was investigated to identify any pending goods inwards or outwards, timing differences or keying errors. If an item was subsequently recounted, as, according to Mr Harrison was normal practice, and the difference was partially or completely resolved, the details of the adjusted entry would be recorded on the exception report.

[24] An invoice or credit to NZE was generated in respect of any unresolved negative or positive variance respectively. That was in accordance with the terms of

the contract between Pegasus and NZE. When Pegasus issued an invoice to NZE in respect of a negative discrepancy, it deducted the goods invoiced from current stock levels in Pegasus' records. Stock levels were increased by the amount of any positive variation. The intended effect of issuing an invoice or credit to NZE was to correct the quantities held in Pegasus's system and make NZE accountable for the value of stock losses in accordance with the contract. Through this process NZE's and Pegasus' systems were brought back into balance.

Stocktake discrepancies

[25] Mr Harrison said that up until a stocktake completed in June 2004, NZE had completed around three full physical stocktakes, including full reconciliation of the results of the stock count with Pegasus' inventory record. On each occasion the discrepancies identified in those stocktakes were relatively small.

[26] A stock count was undertaken by NZE in March 2004, and NZE sent the report to Pegasus. Pegasus rejected the count without attempting reconciliation because it identified that NZE had miscounted several product lines. Mr Harrison said that it was apparent that there had been miscounting because there were product lines that Pegasus stored with NZE for which there was no count at all. The report itself also had calculation errors. Mr Harrison said he would not describe the March 2004 exercise as a stocktake as the reconciliation and recount phase was never completed. Because of its concerns with the reliability of the count, Pegasus did not adjust its system to reflect the result of the count, and Mr Harrison's evidence was that he believed that NZE reversed the entries it had processed in its perpetual record. Whether or not NZE did reverse the entries is at issue.

[27] The first significant discrepancy following a reconciliation process was identified in a stocktake undertaken by NZE on 9 June 2004. That showed a shortfall in stock with a total value, calculated by Pegasus, of $69,720.33. Pegasus queried this result because of the size of the discrepancy. NZE responded that they were very busy and that therefore the count might not be accurate. Pegasus initially processed stock adjustments in relation to the June 2004 stocktake so that the stock in its inventory system and what had been counted, balanced. It withheld payment

from NZE equal to the value of the missing stock, and requested a second count. When NZE said that it would do another stocktake, Pegasus reversed the initial adjustments so that there would be no double adjustment and consequent distortion of its perpetual record. Again, it is at issue whether NZE also reversed out the entries to its stock records that were consequent on this stocktake.

[28] About two months later, around August 2004, NZE completed its second stocktake, and a similar level of discrepancies to those in the June 2004 stock count were found. Again NZE said that the count might not have been accurate, but it reassured Pegasus that it had rented a new building, that the stock was to be shifted to that building and that a new stock count would be completed after the shift. Pegasus' stock inventory was altered to reflect this count. Pegasus withheld additional payments to NZE, but with the intention that all would be sorted out in a stock count at the new premises in February of the following year.

[29] NZE moved into its new building in Donner Place in September 2004. Mr Harrison anticipated that the stock would be stored correctly in NZE's new building, it would then be counted, and discrepancies resolved. But he said that between September and December 2004 there were a large number of short deliveries to customers where both NZE's and Pegasus' perpetual records indicated the items were in stock. Pegasus progressively issued invoices for the short deliveries to NZE up to April with a total value of $48,295 plus GST. Corresponding reductions in the stock levels for the invoiced items were processed in Pegasus' stock inventory.

[30] In February 2005 NZE undertook another stocktake. On this occasion a very substantial negative variance was identified. Pegasus valued the amount of missing stock identified on this stocktake at $304,525.43. Mr Harrison said that discussions took place between NZE and Pegasus in an attempt to resolve the discrepancies on a product by product basis. The discrepancies were not resolved. Ultimately NZE promised that it would reimburse Pegasus for the shortfall in the stock, but went into liquidation in early May without having done so.

[31] Pegasus first began to suspect that stock had been stolen around the time of this stocktake. Pegasus received an anonymous email from a previous employee of NZE which said:

> If you want to know what is happening to your stock, it is thieves and damages.

NZE was contacted and told of the email. As a result of that information NZE started an investigation. It engaged a private investigation firm and with its assistance covert cameras at both of NZE's warehouses were installed. Over the two weeks that those cameras were in operation, 13 NZE staff were identified stealing stock from NZE's warehouses; half of NZE's warehouse employees at the time. The private investigation firm interviewed 10 of the staff involved - the remaining three resigned before they could be interviewed.

[32] In April, NZE, through its broker Mr Allan Cameron, notified AHA of a potential claim. AHA was told that there was evidence of employee theft of stock belonging to third parties, including Pegasus. In accordance with its standard practice AHA responded that its involvement with the claim would be "on a without prejudice basis". It sought the approval of NZE to appoint Thomas Pasley & Associated Ltd, loss adjusters, to investigate the claim. Thomas Pasley recommended that an independent stocktake be carried out to verify the stock on hand. It was agreed that Icon Security (Icon), a security company, would carry that out.

Liquidation

[33] Along with Mr Kevin Pitfield, Mr Gareth Hoole was appointed liquidator of NZE in early May 2005. At the time of the liquidation, Mobil NZ, also an NZE customer, acquired a licence to occupy the building to enable it to maintain control of its own stock. Mobil put Chubb Security in charge of the premises. The liquidators continued to progress NZE's insurance claim, and in particular continued with the engagement of Icon to conduct the independent stock count requested by AHA. The physical stock count was completed by Icon staff, with some auditing of the count by Ms Janene Paki of Thomas Pasley.

[34] In late May, a new warehousing company, Monarch, took over the Donner Place warehouse. As Monarch was to be responsible for the stock from then on, it insisted on doing its own stocktake at Pegasus' cost. At the end of a six week period, Monarch confirmed that all stock had been counted and verified. Pegasus received a full stock list from Monarch. Again, discrepancies between the stocktake and Pegasus' records were identified, revealing a significant shortfall on some product lines.

[35] Pegasus' claim against QBE and AHA for lost stock can be broken down into claims for the value of stock identified as missing at the August 2004, February 2005 and the post-liquidation (Monarch) stocktakes, and through the identification of short deliveries.

C. HAS PEGASUS PROVED THAT ITS STOCK HAS BEEN STOLEN, AND IF SO, HOW MUCH?

The parties' submissions

[36] There is a preliminary issue between Pegasus and QBE as to where the onus of proof lies in respect of this issue. QBE says that Pegasus bears the onus of proving that the stock was stolen. It refers to clause 21.3.5 and says that since unexplained loss is not an insured risk, Pegasus must prove that any stock loss has been caused by theft. But Pegasus argues that clause 21.3.5 is an exclusion clause, and relies on the rule that the insurer bears the onus of proving that an exclusion clause applies (*Munro Brice & Co v War Risks Association* [1918] 2 K.B. 78 accepted in New Zealand by Barker J in *Boonham v CE Heath Underwriting and Agency Services (NZ) Limited* (1993) 7 ANZ Insurance Cases 78,103, 78,105). It says that all it need prove is that the stock is lost, and that is sufficient to bring it within the terms of the indemnity clause.

[37] Pegasus is correct that 'it is sufficient for the plaintiff to bring [itself] prima facie within the terms of the promise, leaving it to the defendant to prove that, although prima facie within its terms, the plaintiff's case is in fact within the

excluded exceptional class': *Boonham*. But unless Pegasus can prove theft of its stock to the requisite standard, it will not have brought itself within the provisions of 2.1.1 of the policy. This is because there are two and only two possible explanations for stock shortages at the level revealed; one is inventory error however caused, the other physical loss through theft. If it is inventory error, no stock has been lost; the negative variance on the defendant's case is merely a product of errors in Pegasus' perpetual record. Moreover, the exclusion clauses of both QBE and AHA will apply. If it is theft, then that falls within the indemnity clause in both the NZE and AHA policies.

Pegasus' case on cause and quantity of stock loss

[38] Pegasus accepts that it cannot prove theft of particular items or quantities of stock on particular dates; it says that it is unrealistic to expect or require it to provide evidence of particular occasions of theft, because theft is usually concealed from the victim, as it was in this case. Its case is essentially circumstantial in that it relies on two strands of evidence. The first strand is evidence of stock loss revealed by stock counts, upon reconciliation with Pegasus' perpetual record. Critical to this is the evidence of Mr John Cregten, a forensic accountant who was asked by Pegasus to verify the reliability of its perpetual records and to work from those to undertake an analysis of the level and value of losses. The second strand is evidence about lax security at NZE warehouses, and of widespread theft by NZE staff.

Defendants' case on stock theft

[39] The defendants attack the reliability of Pegasus' perpetual record, upon which much of Mr Cregten's analysis depends. The defendants contend that Pegasus' perpetual record became corrupted by the inclusion of inaccurate information as to stock levels – information obtained by Pegasus from NZE. QBE and AHA's case is that ample opportunity existed for the corruption of Pegasus' system, and that there are indications that it occurred. The defendants also attack Mr Cregten's methodology, and through Mr Kane, their expert, propose other

analyses of records that prove that either no stock or very little stock went missing when stored at NZE's warehouses.

[40] It is first necessary to outline Mr Cregten's evidence in relation to the material loss portion of the claim and then to determine whether Pegasus' perpetual record provided a reliable basis for assessing the level of missing stock. Determination of this issue requires consideration of the defendants' two principal arguments: that NZE's systems were flawed and introduced error into Pegasus', and that NZE's expert's alternative analysis which suggests there is no loss, is to be preferred.

Mr Cregten's evidence

[41] Mr Cregten's evidence covered several topics. He undertook an evaluation of Pegasus' inventory accounting system to determine its integrity in relation to stock volumes and stock costing. He then analysed and formed an opinion as to quantities of missing stock and appropriate values for that stock. His evidence also covered quantification of consequential losses and a calculation of Pegasus' business interruption claim, which I address later.

[42] Mr Cregten conducted a thorough review of Pegasus' system to satisfy himself that it was an appropriate and reliable one. The appropriateness of the system does not seem seriously challenged in the sense that if accurate information was put into it, it would enable Pegasus to accurately monitor stock levels. Mr Graham, the forensic accountant who gave evidence for QBE, confirmed that the information he had as to Pegasus' system was that appropriate checks and balances were in place. What QBE challenges is how the system was operated.

[43] In terms of quantification of missing stock, Mr Cregten said that his approach was to identify a clean starting point for his analysis. He adopted the July 2003 month end because the variance after the physical stocktake undertaken at that time was less than $1,000, with only four inventory items mismatched. He considered this an inconsequential mismatch in the context of a high volume business. As an

example of the volume of stock being managed between NZE and Pegasus, in 2005 he estimated Pegasus handled over 1 million product units.

[44] He then reviewed the "NZE account" which recorded all inventory adjustments between NZE and Pegasus. His review involved:

a) gaining an understanding of the data entry process;

b) understanding the monthly reconciliation process between Pegasus and NZE and examining the adjustments where volume variances were experienced; and

c) considering the process and steps taken when matching of physical counts to perpetual records indicated variances.

From that review he was satisfied that Pegasus' perpetual inventory record formed a reliable basis for assessing stock levels that should have been on hand at any date. He was also satisfied that variances from July 2003 and the June 2004 stocktake were largely reconcilable. Thereafter, material movements began occurring.

[45] Mr Cregten then undertook an analysis of the various components of Pegasus' claim for lost stock.

August 2004 stocktake claim

[46] Mr Cregten reviewed the June and August 2004 stocktakes, noting that the discrepancy identified by Pegasus following the August stocktake was valued by it at $66,024.53 plus GST, for which it invoiced NZE. He said that to the extent that stock may have been missing earlier than August 2004, that was captured at that point and through the invoicing system the systems were reconciled so that the physical stock level and Pegasus' and NZE's perpetual systems were all in balance. Mr Cregten's opinion was that the August invoices issued by Pegasus after the August 2004 stocktake were a reasonable basis for establishing the initial quantification of inventory missing at that time. However, he identified a need to

make adjustments to those. He considered an adjustment necessary to the unit value recorded in Pegasus' system that had been utilised in the invoices, and also to the number of items claimed. He said that the number of items included as missing in these invoices had to be reduced by those that were found in subsequent counts, and those that were identified by him in an audit he undertook.

Short delivery claim

[47] Mr Cregten then addressed the short delivery component of Pegasus's claim. He noted that Pegasus was extremely busy through September to December as that is the pre-Christmas delivery season for the greater part of its product range. Large volumes of goods were received during that period and large volumes were shipped to customers. He referred to the evidence of Mr Harrison that Pegasus progressively issued 33 invoices to NZE up to April for short deliveries totalling a value of $48,295 plus GST.

[48] Pegasus' inventory system recorded the short supplied items as being in existence and then sold. Processing the sales removed the stock from its record of stock on hand. But the customer who was billed had not received them and required a credit against the initial invoice recording the items. NZE had not shipped them because the items could not be found, even though they were recorded as stock on hand in NZE's system. Therefore, Pegasus provided a credit note to the customer and issued an invoice to NZE for those missing items. For that reason, the short deliveries needed to be included in the loss claimed. Again, however, Mr Cregten said the amounts invoiced needed adjustment downward to reflect a different unit price to that utilised by Pegasus, and to deduct items included in the invoices that were subsequently located through the audit process he undertook.

February 2005 stocktake claim

[49] In relation to the claim relating to the February 2005 stocktake the reconciliation between the physical and perpetual records revealed 349 product lines which had negative variances affecting approximately 45,000 items. Pegasus issued

NZE with an invoice for $270,878.12 in relation to these items. Mr Cregten's opinion was again that it was appropriate to use the invoice as a starting point for Pegasus' claim, but that it was necessary to adjust the unit price and also necessary to remove from the claim any items included that were later found in the course of his audit.

Post-liquidation stocktake

[50] Mr Cregten said that he reviewed the stock count sheets completed by Icon (the Icon stock count) when undertaking the liquidator's stocktake. He said he could not see how any accurate stock report could be produced from them, so he did not use them in his assessment of loss. Instead he used the Monarch count as the basis for the loss calculation. Mr Cregten noted that there was ongoing activity in relation to Pegasus' inventory after liquidation.

[51] In May, Pegasus processed 24 orders involving the shipment of 15,534 product units to its customers. Some of this occurred prior to Monarch assuming control of the warehouse. In June, 45 orders and in July, 27 orders equating to 30,602 and 9,208 product units respectively were shipped. Monarch also recorded goods inwards of approximately 53,000 units during this time period. Because of this activity it was necessary to reconcile the systems in relation to these movements, to allow proper identification of variances as follows:

a) Pegasus removed from its perpetual record goods it shipped after liquidation but before the point that its system balanced with Monarch's count.

b) It added goods received into the Donner Place warehouse in the same period.

c) Monarch physically counted what was there, removing items shipped and adding items received while the count process was ongoing.

[52] Mr Cregten's opinion was that, as long as intervening transactions were recorded and treated consistently between the parties and the count was accurately carried out by Monarch, negative variances (referred to as 'unders') and positive variances (referred to as 'overs') at the date of liquidation could be identified. Mr Cregten verified that this process had been carried into effect.

[53] He said that when Pegasus compared its system to Monarch's physical count many product lines were found to have negative variances. This equated to a system generated cost value of $191,320 plus GST. Pegasus sent two invoices for the total amount to NZE on 31 July 2005 which represented the shortfall arising between February 2005 and the date of liquidation. As with previous loss components, however, Mr Cregten did a line by line check to remove any items from that claim which had been subsequently found as identified in his audit. He also reduced the claim to reflect a lesser unit price, in accordance with the analysis detailed below.

Unit price calculation

[54] Mr Cregten analysed what price the units should be valued at for the purposes of Pegasus' claim to indemnity. He noted that indemnity value can be defined in several ways depending on the policy and the insurer. Since indemnity value has not been specifically defined in QBE's Policy he adopted a cost price to value the loss. The invoices that Pegasus had issued were calculated using the cost price value recorded in Pegasus' system. Mr Cregten rejected that as an accurate measure of cost price and proceeded to review the cost price that had been attributed to the missing quantities in the original claim calculation.

[55] Mr Cregten requested Pegasus to retrieve from archive the paperwork supporting the latest landed cost per unit (including purchase orders, suppliers' invoices with freight costs where appropriate and any other relevant information) for every stock code included in the claim. When he considered the actual supply invoices and latest landed costs calculations for some items, he concluded that many of the system-generated costs per unit were overstated relative to landed cost data. He was able to retrieve the latest landed cost information for approximately 40% of the missing stock lines. He noted that on average the landed cost was 17.5% less

then the cost applied in the original invoices issued to NZE by Pegasus. Therefore, for items where there was no supporting invoice, he reduced the cost price by 17.5% to bring it into line with the average adjustment identified.

[56] In relation to the short supply claim, he reduced the value of the invoices issued by Pegasus to NZE by 37.56% (Pegasus' average gross profit margin for the years 2001 to 2005). He did this because the invoices issued to NZE by Pegasus originally reflected selling price rather than cost price.

[57] The results of these investigations and his subsequent analysis can be summarised as follows:

a) August 2004: Pegasus claimed 18,346 items missing. Mr Cregten's investigations subsequently identified that 5,367 of those items had been found. Value attributed to those items by Mr Cregten: $37,993 ex-GST (to be contrasted to a system generated value of $43,093 ex-GST).

b) February 2005: Pegasus claimed 45,111 items missing. Mr Cregten's investigations identified that 13,265 of those items had been found. Value attributed to that stock: $136,559 ex-GST (to be contrasted to a system generated value of $168,106)

c) Short supply claim: Pegasus claimed 4,235 items missing. Mr Cregten's investigations identified that 862 of those items had been found. Value attributed to the missing stock: $24,239 ex-GST (to be contrasted to a system generated value of $38,820 ex-GST).

d) July 2005: Pegasus claims 50,214 missing items. Mr Cregten's investigations identified that 4,955 of those items had been found. Value attributed to those items: $155,578 ex-GST (to be contrasted to the system generated value of $179,458 ex-GST).

[58] Pegasus' indemnity claim for missing stock advanced against both QBE and AHA is then $354,369.

Did NZE's flawed system introduce error into Pegasus' records?

[59] QBE and AHA argue that the key flaw in Mr Cregten's analysis is that he assumes Pegasus' perpetual record is accurate. They argue that reliance is misplaced in light of evidence that the perpetual record was distorted by the inclusion of defective data collected by NZE on completion by it of grossly inadequate physical stocktakes, sloppy inputting and a "glitch" in NZE's system. QBE and AHA's criticisms of the accuracy of the information recorded were summarised by counsel for AHA as follows:

a) NZE had inadequate and deficient stock control procedures generally, with significant potential for error in all areas of NZE's operations.

b) There was a glitch in the NZE computer system which meant that some information was not captured.

c) When the monthly stock lists were supplied by NZE to Pegasus, Pegasus simply imported that information into its own records, without any attempt to reconcile it.

d) The stocktake process was fundamentally flawed, and the movement of stock from Mono to Donner Place exacerbated existing problems.

e) Stock was left behind at Mono Place, and is not missing.

f) Although there were problems with short deliveries, it is more likely these arose through stock being incorrectly picked/packed than through theft, given evidence that stock was found at the warehouse following short shipments being reported. Pegasus' records are not sufficient to prove that the items were missing rather than simply not delivered or not recorded by Pegasus as delivered.

g) Poorly controlled stock movements following liquidation mean that it is not now possible to rely on a comparison of Pegasus' and Monarch's records of stock on hand to calculate what if any stock is missing following the February 2005 stocktake.

[60] I deal with each of these criticisms in turn.

NZE's stock control systems

[61] There was evidence that the Mono Place warehouse was overcrowded prior to the transfer of stock to Donner Place in September 2003. There was also evidence that the Donner Place warehouse was not well set up to receive the stock, and was chaotic, at least initially. Ms Suzanne Hill, NZE's former Auckland business manager gave evidence for Pegasus. She was employed by NZE in October 2004 to oversee the Mono Place and Donner Place warehouses. Her evidence was that there was "lots of potential for error in all areas, inwards, outwards and daily operations".

[62] Against this background it was suggested by the defendants that the innocent, incorrect picking of goods might explain stock shortfall. I accept Mr Harrison's evidence, that if deficiencies in picking led to the delivery of too little or the wrong goods, that would no doubt be raised by the customer. However, if it led to over-delivery, some customers, it might be supposed, would take advantage of this.

[63] Pegasus' principal customer was The Warehouse. Mr Murphy, the warehouse manager employed by NZE to set up the Donner Place warehouse gave evidence for Pegasus. He said that The Warehouse carefully checked deliveries and did raise over-deliveries with NZE. As Pegasus argued, that would have operated as a check on the risk of loss of stock through over delivery. A further and perhaps more significant check on this risk was the process used by transport companies to ensure that they shipped the goods they were paid for, not more and not less.

[64] Mr Birtwistle, a branch manager of one of the transport companies used by NZE for the on-shipment of Pegasus' stock gave evidence on cross-examination that his company was careful to check the cubic meterage of what was shipped to make

sure it was charging in full for its services. If the cubic size of the shipment did not match the ticket NZE generated for the shipment, the transport company's system would have detected this, and generated an additional charge. This would have alerted both NZE and Pegasus to the over-delivery. He said this was standard practice throughout the industry as revenue protection. In light of these two checks on the risk of significant over delivery, I am satisfied that it is a most unlikely source of such a significant level of stock loss.

[65] It was also suggested to Mr Harrison in cross-examination that keying errors could explain the apparent negative variance between stock levels as recorded, and stock level as counted. Mr Harrison acknowledged that keying errors did occur but said that they would be picked up at the time of the monthly reconciliation unless both NZE and Pegasus made identical keying errors which he considered very unlikely. This was corroborated by Mr Cregten's explanation of how the reconciliations operated. As a matter of logic, the monthly reconciliation process would have identified incorrect data in NZE's record attributable to keying errors as there would be a mismatch between the records.

The glitch in NZE's system

[66] Ms Hill described a glitch in NZE's perpetual software during her evidence in chief. She said there was a defect in the software which meant that while a stocktake was being completed, the overnight update of stock movements during the day did not work properly. However, Ms Hill said that once NZE realised this was a problem, it corrected the fault daily until the function was upgraded. During the February stocktake she checked every entry every night, and then again in the morning to ensure the stocktake was not affected by it. I accept Ms Hill's evidence that the effect of that software defect would have been minimal.

Monthly reconciliations by Pegasus

[67] In his analysis Mr Cregten attached significance to the monthly reconciliations of Pegasus' and NZE's perpetual system. These monthly

reconciliations acted as a check on the importation into Pegasus' perpetual record of errors in NZE's records. But the defendants point to evidence that Pegasus ceased monthly reconciliations early on and simply imported NZE's records into Pegasus' system on a monthly basis, without any attempt at reconciliation. For this reason they say, one of the fundamental assumptions made by Mr Cregten is incorrect.

[68] Mr Harrison's evidence was that monthly reconciliations were done. He produced these into evidence for the period up until June 2004. However, during cross-examination he said that monthly reconciliations may not have continued once major discrepancies occurred. The defendants also rely on a statement made to QBE's investigator by Ms Hill that Pegasus simply altered its stock figures weekly to reflect NZE's electronic record. Ms Hill gave evidence in relation to that statement, and said that she had not taken care in its preparation. For reasons I come to shortly, I attach only limited weight to the statement she made to QBE's investigator. I also consider it improbable that Pegasus simply substituted its perpetual inventory stock records with NZE's figures weekly. That would have rendered futile all of Pegasus' efforts to maintain accurate records, and would not have been in its commercial interest.

[69] Mr Cregten's evidence included a description of how Pegasus operated its stock control and recording systems. He said that he examined the monthly reconciliations and the adjustments made following those where volume variances were experienced. He said that where variations occurred these were investigated and steps were taken to correctly record the position. He said that up until liquidation Pegasus captured the variances, positive or negative, and an account receivable issued where the variance could not be resolved. There was no evidence to contradict Mr Cregten's account that Pegasus records showed that monthly reconciliation occurred, and I have no hesitation in accepting his evidence.

Flaws in the stocktake process

[70] It is critical to Pegasus' case that the stocktakes in August and February 2005 and that undertaken by Monarch were accurate. This is so because they are relied upon to quantify loss at the three points in time that they were undertaken. It is also

true because if the stocktakes were significantly inaccurate, the inclusion of the data into Pegasus' system could, as Mr Graham's evidence for QBE emphasised, have destroyed the integrity of the information recorded there.

[71] In the August stocktake a substantial amount of stock was identified as missing and Pegasus adjusted its records to reflect this. There is some lack of clarity as to when exactly the transfer of Pegasus' stock from Mono Place to Donner Place occurred, but it is common ground that the August stock count was undertaken at Mono Place.

[72] In the course of her evidence Ms Hill made a number of criticisms of the stocktake system that NZE operated. It is this evidence that is particularly relied upon by QBE and AHA. She said that NZE did not have proper systems in place for undertaking accurate stocktakes when she began there in late 2004. In her view stocktakes should have been carried out at regular intervals, but NZE did not tend to do that.

[73] She also said that NZE's stocktaking practice was defective in that NZE had not been "freezing" its stock in the sense that it held all stock while counts and reconciliations were completed. Once stock was initially counted, it was then freed up to fill any orders which had been placed by customers. NZE staff were therefore not able to check the original count and carry out any proper reconciliation of the stock. By the time the recount had been conducted, some of the stock originally counted may already have been "picked" to fill an order.

[74] Ms Hill also had the impression that little attempt had been made by NZE to carry out reconciliations of stock following stocktakes. If any discrepancies were revealed by a stocktake, they were simply reported back to NZE's customers, without proper attempts to determine whether the original count was accurate. During cross-examination Ms Hill also said that the warehouses were messy and that the stock was not in any kind of order. She accepted a proposition from counsel that the stock situation was chaotic.

[75] I weigh against Ms Hill's evidence that she was not on site at the Mono Place warehouse prior to October 2004 and cannot give evidence of the processes followed prior to her arrival. Of course, by 2004, NZE's warehousing operations were spread over two warehouses, and both warehousing operations had been subjected to the substantial disruption caused by the shift of stock and staff between the warehouses.

[76] There was no evidence from any NZE staff member as to the quality of the August stocktake based on their observations of that stocktake, and there was no evidence to suggest that the stocktake process utilised for that stocktake had changed in any way from that used prior to 2004. Earlier stocktakes had required only slight adjustment to the Pegasus perpetual record, which is good evidence that they were largely accurate. It is also significant that the unchallenged evidence of Mr Harrison was that the discrepancies revealed in the June 2004 and August 2004 stocktakes were of a similar order.

[77] The next stocktake was undertaken in February 2005 at Donner Place. I have already referred to the inadequacy of the systems in place for the transfer of stock from Mono to Donner Place. Mr Murphy said that when stock was first delivered to Donner Place it was stored in makeshift piles with no racking. There was no proper opportunity to count it, as orders began being filled before the count was undertaken.

[78] Ms Hill agreed that the records of the stock transfer were not accurate and that some stock was left behind at Mono Place. But Ms Hill's evidence was that when she started at NZE she implemented systems to ensure the accuracy of stocktakes undertaken. In particular she took the following steps:

a) Ensured that rolling stocktakes were carried out on a frequent basis at regular intervals. Those stocktakes were done on a daily or perhaps weekly basis, depending on the situation. For example, if a particular customer raised a query about their stock, then NZE might carry out a stocktake on a particular line of that customer's stock, or all of it.

b) Put in place policies to ensure that proper reconciliations of stock were carried out as part of any full stocktake process, rather than any

discrepancies simply being reported back to NZE's customers. As part of that, she ensured that stock was frozen during the stocktake process so that proper re-checks could be carried out.

c) Ensured that NZE's employees used proper count sheets when they were carrying out stocktakes.

[79] In relation to the February stock count, her evidence in chief was that the count and subsequent reconciliation were undertaken using the new policies and procedures she had implemented. Those processes took approximately five days to complete and Pegasus's stock was frozen during that time. She said that it was only after the count and reconciliation was done that adjustments were made to NZE's system. It was also at that point in time, having eliminated other explanations for the discrepancies, that she considered the possibility that stock may have been stolen.

[80] Counsel for QBE and AHA emphasise that Ms Hill's is the only evidence from a former NZE employee that a reconciled stocktake did take place in February 2005. They argue that there is good reason why Ms Hill's evidence on this point should be rejected. First, it is submitted that her evidence supporting the accuracy of this count is inconsistent with her evidence under cross-examination that by February 2005 she was not even close to knocking the system into shape. To a question from counsel for QBE she said:

> I likened it to eating an elephant, you could only do one bite at a time, so you would concentrate on an area, first dispatch, making sure that we moved on to an electronic system for consignments, so we got away from the manual consignment notes which I believe was a big hole, more regular stocktakes, mini stocktakes, investigations when clients reported a differential. Those were the kind of steps that were taken in the background there was also the structured tidy up of stock, which we had started, sort of mid February early March and we started with Anthony Trading. Just because the way the warehouse was structured they were at the back end and we were going to work forward.

[81] However, I see no inconsistency in this evidence; Ms Hill's evidence in chief dealt specifically with the methodology applied by her to the Pegasus count in February 2005. Her evidence that the complete overhaul of the systems in place at

the Donner Place warehouse had not been completed does not mean that a stocktake completed under her supervision would have been flawed by poor process.

[82] Secondly, it is submitted by the defendants that her evidence in chief should be rejected as inconsistent with a statement she had earlier given to QBE's private investigator. That statement was completed at a point in time at which her recollection would have been better, because it was closer to the events she was recalling. In her statement Ms Hill said she did not believe that Pegasus had lost a large amount of stock stored at the NZE warehouses through stock theft. When asked to explain how such a significant level of stock could then be missing she is recorded as saying:

> There was never a reconciled stocktake done on Pegasus goods during my time at NZE. Those stock figures were just never reconciled or investigated. What was on paper and what was on the shelf was never verified. Every week NZE supplied an electronic stock list to Pegasus and Kerrin just altered his stock figures accordingly. He altered his physical inventory every week in his computer system to match NZE's.

[83] Further on in the statement she said:

> Richard Riley had been over and met with Kerrin at Pegasus on the North Shore and discussed with him how to resolve the situation to get payment from NZE etc. At this meeting we suggested shutting everything down for a five day period and getting an independent stock count of Pegasus' stock and fully reconciling it back to when the stock last balanced.

[84] In response to the question from the investigator as to why that did not occur she said:

> Kerrin didn't want an independent in there. He wanted NZE to do the stock count and he didn't want to stop trading long enough to have it done. However, we did convince him to stop trading and the stocktake did take place I think in about February 05. Once again it was done by NZE and was not fully reconciled.

[85] There is an apparent inconsistency between the statements recorded as made by Ms Hill to the private investigator and the evidence that she gave in Court in relation to whether a fully reconciled stocktake took place in February 2005 and whether theft was a possible cause of the stock losses. As a prior inconsistent statement, the statement to the private investigator is relevant in terms of assessing

the reliability of Ms Hill's evidence and her credibility, and also as part of the narrative behind this issue.

[86] When this interview was put to her during the course of cross-examination Ms Hill said that the evidence that she gave in Court was correct. She explained the inconsistency on the basis that she put little thought into the answers she gave to the investigator's questions. She said that she was under a lot of pressure at that time; she was starting a new job and still had a lot of overhang from the liquidation, including pressure from previous staff and from various different agencies wanting her to talk about it. She said that she simply wanted to "get him out of there". When the investigator came back with the typed up answers she assumed that he had recorded things correctly and did not read the answers with care, although acknowledging that she did make handwritten corrections to spelling mistakes.

[87] I accept Ms Hill's evidence that a reconciled stocktake did take place in February 2005. In preferring the evidence she gave in Court I have taken into account the fact that she has no particular interest in the outcome of this litigation. There is no suggestion that she is associated with Mr Harrison in any way. There is therefore no motivation for her to give evidence favourable to Pegasus. Nor is there any suggestion that she has a grievance against the defendants, NZE, or NZE's liquidators.

[88] I have also taken into account that the private investigator's statement is not a verbatim account of what Ms Hill said. It is based on handwritten notes prepared by the private investigator and then transcribed by him and signed by Ms Hill. Ms Hill was being asked by the investigator to address and explore a complex series of events; events she likely felt defensive about at that time. She had after all only recently surrendered responsibility for the running of the warehouse from where the stock was said to have been stolen. Moreover, she dealt with the query at her work, where she could be expected to (and said she did) feel under time pressure, and be distracted by competing demands on her.

[89] I accept Ms Hill's account that she did not approach the preparation of this statement with care and that some of what she said was not accurately recorded.

Although spelling was easy to correct, it would have taken much longer to ensure the true statement recorded a full and accurate record of events affecting Pegasus' stock, and she did not take that time. I contrast the approach she said she took in the preparation of that statement to the way in which she gave her evidence. In her evidence she gave thoughtful, thorough answers, and impressed me as a fair and careful witness.

[90] Furthermore, a file note completed by Mr Harrison of a meeting between himself, Mr Richard Riley and Ms Hill held at Mono Place on 15 March 2005 tends to corroborate Ms Hill's evidence given in Court that a stocktake did take place together with attempts to reconcile the count with the perpetual records, and that by then theft was thought to be a possible explanation for the losses. That file note records Ms Hill as saying that she did not know if the stock was "lost, stolen, missing". The file note also records Mr Riley speculating that the staff might simply not have counted a row of pallets, or failed to count pallets that were in a high position because they could not be bothered. He said the people they were using could not count or check stock properly. That record of the meeting was put to Ms Hill. She said, in relation to Mr Riley's comments, that although he was a director of NZE, he did not work at either the Mono or Donner sites and was not familiar with the counting processes there. She did not accept his account of what may have happened in relation to that stocktake.

[91] No issue is taken with the reliability of the Monarch count. The defendants say, however, that it cannot be relied upon as the basis of a calculation of loss, as it cannot reflect stock movements in the period of time from the date of liquidation to the time Monarch assumed control.

[92] QBE and AHA say that irrespective of the evidence as to NZE's stocktake processes, the evidence of large discrepancies on stocktake show that the stocktakes, and the records derived from the stocktakes, are unreliable. Mr Graham is an expert forensic accountant who was called as an expert witness by QBE and gave evidence on this point. Much of Mr Graham's evidence was in the form of general comment on other evidence and was not, for that reason, helpful. However, he did focus on unders and overs he said were identified following the June 2004 and February 2005

stock counts. He accepted that he did not consider Pegasus' records, and that he relied on an analysis undertaken by Mr Kane of other records.

[93] Relying heavily on Mr Kane's analysis of records, he proposed that the presence of high levels of unders and overs was evidence of flaws in NZE's stocktakes and that this produced inaccurate data. He said that data was ultimately incorporated into, and corrupted Pegasus' system through the monthly reconciliation process and through the inclusion of the results of NZE's stocktakes into Pegasus' system.

[94] There are two principal ways that false unders and overs can occur. The first is a simple miscounting of product. The second is a mis-recording of product which is then counted against another product code. The defendants argue that there was a real risk of the latter kind of error because many of Pegasus' product lines were almost identical. In fact some were identical, the only distinguishing feature of the product being which customer the product was going to.

[95] At a general level, if an item is over-counted because the count includes items with another code, that count will be entered in the records. When a later, accurate count occurs, it will produce a false under. Mr Graham's evidence was that once flawed stocktake counts of this nature are entered into a record, the system becomes irredeemable.

[96] During closing I pressed counsel to clarify what the precise evidence was in relation to unders and overs. Mr Robertson for QBE agreed that the only evidence as to the level of unders and overs was contained in Mr Cregten's evidence in chief where Mr Cregten identified product initially thought to be lost, but listed as an over after subsequent counts. Mr Cregten explained the process by which he identified the unders and overs. The unders are the items originally included in the invoices issued by Pegasus to NZE. He said that to the extent items identified as lost subsequently appeared as overs, he regarded the item as found, and to be removed from Pegasus' claim. Since overs were entered into Pegasus' stock system by either issuing a credit note to NZE or by processing a journal entry, he caused a line by line review of credit notes and journals to be undertaken. Where items included in the

loss claimed were found, they were removed from the loss calculation. The overs that QBE refers to are the items found.

[97] As should be plain from this description, Mr Cregten's evidence is not demonstrative of overs caused by a misattribution of stock code. Since Mr Cregten was able to identify the overs as stock previously thought to be missing, I infer it must have been correctly identified at the point at which it was an over.

[98] I accept that were a misattribution of stock during a count to result in a false over in Pegasus' records, on a subsequent accurate count, that error could lead to a false under, and a claim for missing stock. I also accept that such a miscount is a reasonable possibility since the evidence is that some of Pegasus' product lines are almost identical to other product lines, sometimes differentiated only by the customer coding. Although Pegasus accepts this as a theoretical possibility it says that there is no evidence that this in fact occurred. In any case, the reconciliation exercise undertaken by Pegasus, as verified by Mr Cregten, would have identified such an error.

[99] I have considered the defendants' argument that the problem was more widespread than identified by Mr Cregten because, as he admitted, he only undertook the audit for unders and overs for the product lines for which a claim was being made. If the unders and overs resulted from product misdescription and consequent false counting, Mr Cregten's process would not pick the problem up. However, the difficulty with the defendants' hypothesis is that first, I have no evidence of the level of such unders and overs and secondly, as Mr Harrison made clear, Pegasus did not simply accept stocktake results without an attempt to reconcile any variances. It could be expected that a misdescription error would be picked up where the error resulted from a small difference in stock codes, the most likely form of product misdescription to have occurred. The reconciliation could be expected to eliminate such misdescriptions. Mr Cregten said that his review of Pegasus' systems confirmed that they did, during the reconciliation process, look at product on a line by line basis and identify product misdescriptions and correct them.

[100] There is another difficulty with the defendants' theory that product mis-description and resulting unders and overs could explain the loss. For this error to produce a false under, there has to have been a false over in the preceding count. Thus, in respect of the August count, a false over in a preceding count would mean that when a comparison of a later count was made against that stock item in August, a false under would be produced. A claim would then be made for what would be a false under. The problem with this defence theory is that it does not explain the unders revealed by the August 2004 claim, or why the level of unders remained largely consistent between the June 2004 count and the August 2004 count.

[101] I find significant deficiencies in Mr Graham's line of reasoning that led him to conclude that NZE's stocktakes must have been flawed, and that Pegasus' records were corrupted by inaccurate information. First, there is no evidence of high levels of unders and overs of the type he refers to, arising from misattribution of stock codes. Secondly, misattribution of stock code more likely than not would have been picked up through the reconciliation process. Finally, Mr Cregten's audit identified and set off false unders and overs arising from miscounting.

[102] I am therefore satisfied that the three stocktakes that form an integral part of Pegasus' claim were properly reconciled and are sufficiently reliable that they would not have distorted Pegasus' perpetual record.

Stock left behind

[103] Mr Robertson suggested to Mr Cregten during cross-examination that product might have been stored at Pegasus' head office that it was now claiming for as missing stock. However, there seemed to be no proper evidential basis for that proposition. It was not pursued in closing submissions.

[104] Mr Hoole, one of NZE's liquidators said that during the stock count and removal of stock from Mono Place at least two pallets of Pegasus' stock items were found. He said he recalled there was some cricket gear but he did not look at it in detail. Mr Hoole said he contacted Mr Harrison about this stock and asked him to uplift it, but accepted that he had no record of the stock or of contacting Mr Harrison.

Mr Harrison denies that he was contacted by Mr Hoole about stock at the Mono Place warehouse.

[105] I have no hesitation in accepting Mr Harrison's account that Mr Hoole did not contact him. Given the issues between NZE and Pegasus in relation to allegations of stolen stock, and outstanding warehouse fees it is improbable that Mr Hoole would not have carefully documented the nature and volume of the stock found, or have recorded its delivery to Mr Harrison. I very much doubt that the stock Mr Hoole refers to existed.

Short deliveries

[106] In relation to the short delivery claim, QBE's expert witness Mr Kane said that he had completed a review of the 12 biggest invoices that comprised 66% of the claim for short deliveries. In his view, in all cases there appeared to be a valid explanation for why the stock may not have been delivered to customers. These were that:

a) Sufficient stock for three of the orders appeared to have been transferred to another location (via a bin transfer), so that the stock was somewhere in the greater warehouse. One of the stock items was later transferred back to its original location.

b) NZE stock records showed that it did not have enough stock to fill the order quantity for four of the orders, which seems to contradict Pegasus' account that NZE's stock records showed enough stock to fill the order.

c) Three orders were in fact delivered.

d) In respect of two of the orders there appeared to be enough stock on hand to fill the orders.

[107] Mr Kane's evidence was subject to extensive challenge through cross-examination. As I come to shortly it is fair to say that at the conclusion of that cross-examination, I was satisfied that I could attach very little weight to his evidence. In relation to this topic particularly there was no evidential basis provided for his conclusions. He was not a witness of fact, but an expert witness. Although he claimed there were records to substantiate his claims he did not produce them. He confirmed that in expressing these views he relied on the records he had obtained, that were referred to as the "Balance" records, which he said showed that the items had subsequently been found. The Balance records were, he understood, a clone of NZE's records, provided to him by NZE's software provider. Again, for reasons which I come to below, I do not consider that any reliance can be placed on those records.

[108] In any case, if the items were subsequently found, I am satisfied this would already be accounted for in Pegasus's claim by reason of the line by line audit Mr Cregten undertook to eliminate claims where the item was subsequently discovered.

Post-February 2005 stock loss

[109] If the February stocktake and Monarch count are accepted as accurate, then the defendants must point to defects in the recording of stock movements in and out of the Donner Place warehouse to resist the conclusion based on Mr Cregten's evidence that stock has gone missing. The accuracy of the Monarch count was, by the time of closing addresses, not disputed by the defendants, and I have found that the February stocktake was similarly reliable.

[110] In reliance upon the evidence of Mr Kane, the defendants argue that the Monarch count is an unreliable basis for this calculation. Mr Kane said that the main issue with finding a final stock count for Monarch was in accurately determining the volume of stock movements for the period between the date the liquidators relinquished control and the date Monarch took control of the premises. He said that orders had been processed in that period but there was no way to verify the impact that those orders had upon Pegasus' or Monarch's records. It was possible that

movements had occurred which were not reflected adequately in either. If Mr Kane's estimate of that stock is included in these figures, Monarch's stock count should be lifted to 322,504 stock items.

[111] Mr Cregten's evidence was that he was satisfied that Pegasus stock delivered to customers after liquidation was deducted from Pegasus' perpetual record, and stock delivered to the warehouse after Monarch assumed control was added to both Pegasus' and Monarch's stock record. The methodology set out in Mr Cregten's brief satisfies me that the stock movements post-liquidation were adequately recorded by Pegasus and Monarch, so that this quantification of missing stock can be relied upon. Since Mr Kane did not check Pegasus' records to attempt to verify or contradict this, there is nothing to contradict Mr Cregten's careful analysis of these records.

Does QBE's experts' alternative analysis demonstrate that Pegasus suffered no loss?

[112] The defendants rely on the evidence of QBE's experts (particularly Mr Kane) to argue that Mr Cregten's methodology is flawed, because he has failed to step back and look at total stock volumes, proceeding instead on the basis of a product line by product line comparison. They conclude that if total stock numbers are considered, it is more likely than not that no or very little stock is missing.

Mr Kane's evidence

[113] Mr Kane was called by QBE to give expert evidence as to whether Pegasus had suffered the losses claimed. He created an alternative model for calculating stock levels to that proposed by Mr Cregten, using records other than Pegasus'. For reasons he did not adequately explain, he did not examine Pegasus' system. The exercise Mr Kane undertook was done on the basis of comparing information NZE's liquidator provided to him as follows:

a) A "final list of stock" held by NZE dated 8 May 2005 provided to him by the liquidator which he understood from the liquidator had been generated from NZE's records;

b) A list of stock on hand on 6 May 2005 which he understood from the liquidator, to be taken from Pegasus' perpetual stock records;

c) The records of the physical stock count completed by Icon between 10 and 18 May 2005; and

d) The perpetual stock records of Monarch in relation to Pegasus stock, which were run on 29 July 2005.

[114] Mr Kane observed that the records showed similar total numbers of stock units, and not the kind of differences he would have expected given the level of stock loss alleged. However, in making this observation, he failed to note that the stock records he worked from record stock levels at different dates; I attach no weight to this observation as it seems to have been a passing remark made in the course of his evidence in chief. Mr Kane synthesised Pegasus' and NZE's stock lists and the Monarch record of its physical stock count into an excel spreadsheet. He did this to enable him to use the Icon count information to compare to the three stock lists provided.

[115] He said he satisfied himself as to the reliability of the Icon stock count by personally undertaking an audit of the stock count sheets. However, in the course of cross-examination he had to accept that he had no basis to assert that the Icon stock count was reliable, since he relied entirely upon the content of the stock count sheets. He did not speak to anyone involved in the stock count to verify the methodology used or its reliability. Given that he was relying entirely on the sheets, it is significant that he did not check how they were completed, or how they were to be interpreted. The only person with whom he discussed the sheets was the liquidator, but Mr Hoole had no useful knowledge in relation to the stock count since neither he nor his staff were involved in it.

[116] Having undertaken the audit, Mr Kane concluded that the Icon stock count showed that NZE had more stock items on hand than NZE's or Pegasus' stock records disclosed. Indeed, he concluded that taking a very conservative approach the final total count of stock for Icon was 346,772 units. He noted that the level of stock Icon said was actually on hand at liquidation included a significant number of unmatched stock items which suggested issues with Mr Cregten's line by line approach. It was Mr Kane's contention that Mr Cregten should have looked at total stock numbers, netting off unders and overs, rather than analysing particular product lines. In relation to this issue I accept Mr Cregten's evidence that the methodology employed by Mr Kane is not appropriate for stock analysis. Mr Cregten said that the accepted methodology for stock loss analysis and stock valuation is to analyse stock on an item by item basis, and indeed, under cross-examination, Mr Kane also accepted that was the appropriate methodology. In particular he accepted that if stock is stored in a warehouse facility utilised by more than one customer, the risk is that a third party's stock will be included in the count. The line by line methodology reduces that risk.

[117] Mr Kane also said that the Icon count highlighted NZE's apparent poor stock control practices, with small quantities of stock belonging to one client being mixed with stock belonging to other clients, and small amounts of one type of stock being held in multiple locations within the greater warehouse. He relied on the very high stock unit level revealed by the Icon count to bolster his opinion that no stock was missing as at the date of liquidation, and to add weight to his proposition that either stock went missing after liquidation, or the Monarch count was inaccurate.

[118] NZE's perpetual stock system was supplied and maintained by an external provider, Balance. Because all of NZE's stock records were held by Balance, Mr Kane contacted the Balance support staff and asked them to provide him with a full list of every transaction record from the point at which Pegasus' stock was first entered into NZE's system until the date of liquidation. In response to this request he received an electronic file. This file comprised approximately 120,000 lines of data recording approximately 120,000 transactions in and out of NZE's stock system in respect of Pegasus stock. This was from the point at which Pegasus first used NZE to the date of liquidation, that is from December 2001 to May 2005. Although

the records he obtained from Balance formed the evidential foundation for a significant part of his evidence he said he had not produced a hard copy of the Balance file because it comprised approximately 2,000 to 2,500 pages of data.

[119] Mr Kane said the Balance records were in effect a clone of NZE records, but it was not clear how he had satisfied himself of that. Nor was it clear why he had worked from these records when the liquidator's evidence was that the NZE records were still available.

[120] Mr Kane said that he reformatted the data into a schedule containing all stock movements, inwards, outwards or adjustments into schedules. He created a matrix whereby the stock movements should have reconciled to opening stock less closing stock. He did this so he could check the integrity of the data contained in the individual stock movement records. In essence, what he was doing was starting with zero stock and then checking the stock movements to ensure that they reconciled with the final stock figure contained in the NZE stock list of 315,350 stock items. His hypothesis was that if the movement records were accurate, they should reconcile exactly with the stock items shown in NZE's stock list as at the date of liquidation.

[121] As the movement records did not immediately reconcile, he determined that a number of manual adjustments should be made to the record to correct a mixture of system errors and user input issues which he considered had occurred in the March 2004 and June 2004 stocktakes. Once these adjustments were processed the Balance record was able to be reconciled to the final stock item number shown in the NZE stock list at the date of liquidation, which was 315,300. They were able to be reconciled in the sense that if you took the starting point of zero stock items, then examined all stock movements shown in the Balance records, these reconciled to the final NZE stock levels shown in the print out he got from the liquidator.

[122] In Mr Kane's opinion, without these adjustments, NZE's records did not reconcile internally themselves, and it was unlikely they were ever synchronised with Pegasus' records.

[123] Pegasus objected to the admissibility of the Balance records, and to that portion of Mr Kane's evidence which relied on his analysis of those records. Mr Robertson for QBE confirmed that that objection had been signalled to QBE at the commencement of the trial. Mr Tingey for Pegasus grounded his objection on the fact that the records had not been produced into evidence through a witness who had knowledge of the records and how they were created. He also objected on the basis that the records had not been disclosed to Pegasus by QBE, and Pegasus' experts had not had an opportunity to consider and comment on them. I declined that application and provided my reasons at that time. I did not, however, rule on the admissibility of Mr Kane's evidence, or Mr Graham's evidence where it touched on these records. It was agreed at the commencement of Mr Kane's evidence that I would receive it provisionally under s 14 of the Evidence Act 2006 and rule on its admissibility at a later point.

[124] The objection to the admissibility of Mr Kane's evidence (in so far as it relies on the Balance records) remains for me to determine. The absence of proof of the factual foundation for Mr Kane's opinion could be so significant as to render the evidence inadmissible. In this case, however, he was extensively cross-examined in relation to the evidence, and I am satisfied the appropriate way to take into account the absence of proof of the record Mr Kane has relied upon is in terms of the weight to be given to his evidence.

[125] Mr Kane's qualification and independence as an expert were challenged by Pegasus. During the course of cross-examination of Mr Kane it emerged that he has no particular expertise in the area upon which he purports to give expert evidence, namely stock reconciliation and stock counts. He was employed by Staples Rodway on a contract basis. He is an accountant and had previously worked at Credit Suisse, but that work had nothing to do with forensic analysis, inventory or stock control. His job at the time of giving evidence was as a risk manager for ING and again did not involve issues pertaining to inventory stock control or forensic analyses of accounting records.

[126] I am also satisfied that there are grounds for concern as to Mr Kane's objectivity based on how he came to be undertaking the analysis that formed the

basis of his evidence. He was initially contracted by the liquidators to assist in the liquidation of NZE. It was in this capacity that he commenced his investigations. With the consent of the liquidators his report was made available to QBE for this exercise on the basis that QBE shared the cost of its preparation. Both Mr Hoole and Mr Kane denied that the liquidators had any particular interest in proving that Pegasus had not lost stock. But the debt owed by Pegasus for warehousing services was an asset of NZE that would be irrecoverable if stock had been stolen. The liquidators' interest in the outcome of the investigation had disappeared by the time Mr Kane gave evidence, because the liquidation had terminated by that time. But Mr Kane's interest, as the liquidators' contractor, in the outcome of his investigations at the commencement of the project is something that has to be weighed in assessing his evidence.

[127] More significant, however, was the lack of care shown by Mr Kane in the preparation of his evidence. This lack of care is perhaps best revealed by his treatment of the Icon stock count. By the end of the trial it was accepted by both AHA and QBE that no reliance could be placed upon the Icon stock count. It seemed likely that the methodology employed in the count process itself was defective; items were not counted properly and possibly over-counted, and product codes were not properly utilised. The full stock count (the synthesis of the count sheets completed by the Icon staff) was not completed until well over a year after the count sheets had been completed, and was completed by the liquidators' staff under Mr Kane's direction, not by the Icon staff.

[128] It is no doubt because of his casual approach that Mr Kane assumed that two of the columns in the stock count sheets should be multiplied to arrive at an accurate stock unit count. But it was a mistake to multiply those two columns. The effect of this error was to grossly overstate the number of stock items counted by Icon in instances where that multiplication exercise was undertaken. He accepted that the minimum error was 70,000 items of a total stock count, by his estimate of 400,000.

[129] As I noted earlier, Mr Cregten rejected the Icon count as a reliable basis for any analysis of stock levels. The reasons he provided for this view are compelling. I list just a few. The count sheets are difficult to follow and identification of items and

values is problematic. No totals are provided. Mr Kane used his own judgment to create those totals over a year later. Mr Cregten said that he knew of no stocktaking procedure which would advocate such a course of action. Further, the ultimate outputs from the count showed a very large number of unidentifiable items and significant variations. Mr Cregten said his review indicated that 83,389 items out of 400,124 (20%) could not be matched to NZE records. 156 product lines out of 720, involving 151,729 items out of the count of 400,124, had variances greater than $1,000 against NZE's perpetual records.

[130] Although Mr Kane expressed the opinion that the Icon stock count was reliable, he must have recognised the implausibility of that when the very large number of product items that were counted suggested otherwise. But still, in his evidence he continued to attempt to utilise that count as the basis, in part, for his criticism of Mr Cregten's conclusions. This suggests either carelessness or a troubling lack of impartiality in the preparation and presentation of his evidence. Of course, one obvious attraction the Icon count has over other counts is that on its face at least, it bolsters QBE's position that Pegasus has not lost stock through large scale theft.

[131] Another central plank of Mr Kane's evidence was the review he did of the NZE stock list. The same themes that emerged in his approach to the Icon stock count are again apparent. He took little care in understanding the source of the records that he utilised, nor did he attempt to establish their reliability. He received a print out of NZE stock as at the date of liquidation which he did not obtain from the NZE system himself, but was handed by Mr Hoole. He did not speak to any NZE staff member to verify its contents or how it should be interpreted. He did, however, compare it to documents that he received from Balance, which he claimed contained all the entries processed through the NZE system. As noted above, again he did not undertake any verification process as to the reliability of that record.

[132] Given the lack of care with which Mr Kane approached his analyses, I have no hesitation in concluding that it would be inappropriate to rely on the NZE or Balance records as adjusted by him to reach any conclusion. I am reinforced in this view by the following obvious deficiencies: He has processed adjustments in the

Balance records to correct adjustments made for the March and June 2004 stocktakes but Mr Harrison's evidence was that no adjustments were processed in Pegasus' records for the March count and adjustments for the June count were reversed out. Mr Harrison also said that he believed that NZE reversed any adjustments it made in respect of these counts. Mr Cregten was satisfied that NZE did reverse any adjustments, because he said that if they had not been reversed that would have been immediately apparent the next time Pegasus and NZE compared their systems. On this basis I am satisfied that Mr Kane cannot be correct that NZE's system reflected adjustments for the March and June 2004 counts. If those reversals do not appear in the records from which Mr Kane has worked, they are not a clone of the NZE records. But if the reversing entries do exist, then the entries he described in his evidence correcting entries already reversed will have corrupted the record. Either way the exercise he has undertaken is futile.

[133] Mr Kane also makes no mention in his evidence of entries in the Balance records in relation to the August stocktake. Such a stocktake did occur, and there were adjustments to the perpetual records of NZE and Pegasus as a consequence. If they were absent from the Balance records that he worked from this further suggests that those records were not a clone of NZE's records. Mr Kane did not seem to be aware of the August stocktake.

[134] Since Mr Graham's evidence is largely dependent on Mr Kane's evidence, which I have rejected as unreliable, I do not attach any weight to Mr Graham's evidence as to the significance of a netting off of unders and overs.

Conclusion

[135] To conclude, I am satisfied that Mr Cregten's methodology was appropriate and the key factual premise of his opinion, that Pegasus' records were reliable, correct. I am also satisfied that QBE's experts alternative models that show little or no stock missing, are flawed. It follows that the first strand of Pegasus' case, that its stock was missing, is made out. This was not simply a case of error in the inventory records.

Is there any other evidence that Pegasus' stock was being stolen?

[136] It is now necessary to address the second strand of Pegasus' case – the evidence that its product was being stolen by NZE staff. Pegasus' case is that there is evidence that many staff at NZE were involved in theft of Pegasus' product. There was, in effect, a widespread culture of theft existing within a business where there was also widespread opportunity for such conduct. Pegasus concedes that although it can point to a significant amount of evidence that there was theft, it cannot prove theft of a particular stock on a particular occasion, but argues that it is unrealistic to expect that it produce such evidence. An inherent difficulty with proving theft is that allegations will be denied and evidence concealed, and it is highly improbable that the thieves themselves will come forward and admit to stealing stock on a large scale.

[137] The defendants both say that Pegasus has failed to prove that anything more than trifling, petty theft was occurring and that its proof has gone no further than establishing the risk of theft, which is not enough. It is submitted that Pegasus is asking the Court to infer, on the basis of lax security, inadequate systems and a small amount of provable theft, that enormous volumes of low value stock belonging to Pegasus were stolen in a 12 month period. Pegasus' case requires the Court to accept that one or more unknown employees unlawfully took large quantities of stock to unknown destinations on a regular, probably daily, basis without anyone seeing it or detecting it. The level of theft would have to involve supply to some other party at a commercial level. They argue that given the paucity of evidence, the Court cannot be satisfied on the evidence that theft is more likely to have occurred than not.

Opportunity for theft

[138] There is a significant volume of evidence to suggest that there was *opportunity* for theft on the scale that Pegasus alleges. Apart from the two week period during which Securitek operated surveillance cameras, there were no security cameras on site. Nor was there security on the main gates to the Donner Place

warehouse to check the identity of vehicles going into and out of the premises. The inwards goods door at the Donner Place warehouse was left open all day. That was the door furthermost from warehouse management and could not be monitored from where management sat. This meant that it would have been possible for a vehicle to drive around to the inwards goods area, load product out of the warehouse and drive away without being observed by management.

[139] Many employees had out of hours access to the warehouse, and the code for the alarm on site. There was evidence that without any proper reason for being there, staff members were frequently at the NZE warehouse outside of work hours. Staff members were found at the warehouse during weekends and before the warehouse opened on weekdays.

[140] There was no supervisor on site at all for the last three hours that staff were working at the warehouse. The principal supervisor at the site, Mr Gentry, divided his time between the Mono Place and Donner Place warehouses so that he was often absent from the Donner Place warehouse. When he was away from the warehouse, he left two others as acting supervisors. The evidence suggests that those two others were involved in the theft that was going on.

[141] The defendants rely on the evidence of Ms Hill that in the three weeks to a month prior to liquidation she performed random checks, turning up to the Donner Place warehouse three to five nights per week. She would walk her dogs around from where she lived to that area. She was looking for anything out of the ordinary because at that stage she suspected that theft was occurring during the night shift. AHA also relies on the evidence that Ms Hill did not see any theft other than the theft recorded on the security footage. Other employees who gave evidence also said they saw no theft.

[142] But Ms Hill's evidence was that during work hours her time at Donner Place was limited. Even if her random evening checks are included in her time there, it is unlikely that she would have detected anything but the crudest and most blatant attempts at theft. As to the other staff who said that they did not witness theft, one of

those was implicated in the theft and refused to answer questions claiming privilege against self-incrimination.

[143] It is improbable that anyone who was implicated in theft would come forward as a witness to give evidence as to what they had seen. Moreover, there were family relationships and friendships operating within the work place, so that even if not personally implicated in the theft, some staff might be reluctant to describe what they had seen. It is clear that not all staff at NZE were involved in the theft and I heard evidence from NZE staff who I have no doubt would have given evidence as to any theft they had observed. But the simple point is that although one or two staff members said they did not witness theft, it is now clear that theft was frequently occurring.

[144] There was also evidence of deficiencies in the consignment system which provided an ongoing opportunity for large scale theft. Ms Hill said that key gaps in the system at NZE included failures on the part of NZE to reconcile purchase orders from Pegasus' customers with delivery consignment notes and consignment notes with invoices received from various trucking companies. This meant that it would have been possible for an NZE employee to write out a manual consignment note and have stock from NZE's warehouse sent to where the employee wanted, but to not enter that consignment into NZE's system. If there was no purchase order for that stock, then NZE's system would have shown that the stock was still in a warehouse. It is true that there is no evidence of this occurring on any particular occasion, but it is nevertheless evidence that there were methods by which large volumes of stock could feasibly be removed from the site.

[145] There was also evidence of a one-off opportunity for large scale theft generated by the shift of stock from the warehouse at Mono Place to the warehouse at Donner Place. Mr Murphy's evidence was that the process for transporting stock between the two sites was inadequate. A number of trucks were used for the stock transfer and the stock was simply unloaded at the Donner Place warehouse and floor stacked. A pallet label was created and copied for each pallet, one attached to the pallet, and one given to Mr Murphy so he could transfer the stock into the system. It was intended that stock would be counted and reconciled against this information.

However, before that could be done some of the stock had already been "picked" for orders. Mr Murphy said that the count which he completed as the stock arrived was therefore not adequate to check that stock shipped from Mono Place was received at Donner Place. Although he could not say if any stock went missing during that period, there was ample opportunity for stock to be taken during the process, and if it had been, there were inadequate safeguards in place to ensure that that would have been detected.

[146] On the basis of the systems operating at the Donner Place warehouse I am satisfied that there was ample opportunity for large scale theft of stock. The next issue that arises is what evidence there was that theft did take place. The defendants submit that the evidence relied upon by Pegasus establishes no more than petty pilfering, and is inconsistent with the notion of large scale theft. For example, in relation to the September covert surveillance investigation in April 2005, the theft recorded was on a minor scale. Over the two-and-a-half week period that surveillance was carried out at Donner Place, losses were identified in the footage totalling only $413.03 for Pegasus. On an annual basis that would be approximately $11,000 worth of theft.

[147] Mr West, a director of Securitek gave evidence as to the investigative measures Securitek took when instructed by NZE. He said that while Donner Place only had two security cameras operating as part of that surveillance, one of them was focused on the "complete staff carpark". Mr West said that if product was taken by staff out of another door and put into their cars it would have been detected on that footage. He recalled footage of someone walking from a different area who appeared in the camera view and placed something in their boot.

[148] The defendants submit that the theft recorded on the tapes was on a completely different scale to what is alleged by Pegasus. QBE submits that by reference to the nature of the stock (large quantities of small value items) theft at the level alleged would require huge volumes of product to be removed from the warehouse without detection. Approximately $1,177 of Pegasus' goods would need to have been removed on a daily basis. QBE submits that it is significant that the

biggest part of the claim for lost stock relates to theft occurring after the February stocktake and prior to the liquidation on 6 May 2005.

Scale of theft of Pegasus' product

[149] Pegasus received the initial communication from a previous employee of NZE referring to theft in February 2005. Attempts to obtain further information were unsuccessful because the employee refused to provide it. However, the Securitek footage captured half of NZE's staff stealing stock. In particular it is of note that the security camera filmed only one out of eight exits. I accept Pegasus' argument that the camera at Donner Place does not provide a complete picture of what was occurring in that two-and-a-half week period in terms of quantities stolen, let alone over the rest of the period that the Donner Place warehouse was operating, and with which this claim is concerned. What it shows, however, is relatively unrestrained and widespread theft.

[150] One of the supervisors who gave evidence, who also admitted to theft, said that he saw other staff members stealing stock on at least two out of five days every working week, he saw employees walking out with cartons full of stock and saw one employee back his car up to the warehouse and spend 20 minutes filling it with stock. The same employee admitted he was caught selling Pegasus stock at a garage sale, but he said "[e]verybody was guilty of theft". He said it was a "free for all", and that he knew if anything was taken he would never get caught.

[151] One employee was seen by staff running from the warehouse with stock, and was never seen again. There is also evidence that there was a practice operating of throwing stock over the back fence of the property, to be collected later in the day. Mr Rodriquez, a former NZE employee, said that Mobil had its own stocktaking processes operating at the Donner warehouse yet he confirmed that Mobil stock also went missing.

[152] Another client of NZE, Mr O'Shannessey of Anthony Trading Ltd, gave evidence not challenged by QBE or AHA, that he had $20,000 of stock stolen from NZE. That amounted to 14.5% of Anthony Trading's stock stored at NZE, and the

cost of the items ranged from 99 cents through to $1,800. Like Pegasus, Mr O'Shannessey said that Anthony Trading had been warned to get its stock out of the NZE warehouse because it was going missing. Mr O'Shannessey said that some of the items that were stolen were large, such as sofas. Transportation would of course be needed in the theft of such a large item.

[153] QBE called Mr Birtwistle, the branch manager of a transport company used by NZE. He expressed the opinion that it was not possible for the amount of stock claimed by Pegasus to go missing without being noticed. He said that his transport company was used by NZE to move stock held by NZE for Mobil, picking up or delivering the product to the Donner Place warehouse. His evidence was that to reach a value of $500,000 a significant proportion of Pegasus' stock would have to have been taken, and that would have been noticed. It would also have required a full "B train" (a truck towing two trailer units) to shift.

[154] But Mr Birtwistle accepted that he gave his evidence in chief on the assumption that Pegasus had lost $500,000 of stock, comprising 300 pallets of goods, and that the warehouse from where it went missing stored 700-800 pallets. He acknowledged under cross-examination that to assess the number of pallets missing, it would be necessary to work through precisely what stock was alleged to be missing, and make a calculation based on volume in the light of that. He had not undertaken that exercise. He accepted that he had assumed without checking that the total number of pallets in the warehouse was 700 to 800 pallets, and that if there were 7,000 pallets that would make a difference to his opinion. He also accepted that in expressing his opinion he did not take into account the period of time over which Pegasus had lost its stock. I do not therefore attach any weight to his opinion in this regard.

[155] Given the numbers of staff involved in the theft, the apparently open way in which stock was being stolen, and the rate of theft in the small sample of events within the warehouse captured on the Securitek footage as well as that described by NZE staff, I am satisfied that it is more likely than not that theft of Pegasus' stock occurred frequently, in large volumes and over an extended period of time. That this is so is corroborated to some extent by the theft of Anthony Trading product.

D. CLAIM AGAINST QBE

Is Pegasus entitled to indemnity for lost stock, and if so, for what amount?

[156] Pegasus has proved that stock has been lost by reason of staff theft at NZE. It has brought itself within the terms of clause 21.1.1. I am also satisfied that exclusion clause 21.3.5 has no application, as this is not an unexplained disappearance, nor is it a shortage due to accounting or clerical errors. QBE suggested an interpretation of the exclusion clause whereby the obligation to indemnify is also excluded if the shortage is revealed at any stocktaking. But I am satisfied that the only coherent reading of the clause is that the expression "shortages revealed at any stocktaking" follows on from and is qualified by "unexplained disappearance". To be clear, the clause excludes liability to indemnify for unexplained disappearances revealed at any stocktaking. It follows that Pegasus is entitled to indemnity for the value of stock which it has proved is missing by reason of theft.

[157] As to the quantity of missing stock, I proceed on the basis of Mr Cregten's evidence. Although Pegasus' claim was initially based on the system generated cost price of the goods, during the course of the hearing Pegasus accepted that it could not claim more than the valuation offered by its own expert, Mr Cregten. QBE or AHA did not seriously dispute that valuation. Mr Kane criticised the valuation utilised by Pegasus, but during cross-examination agreed that his criticism was directed at the system-generated valuation and not the adjusted figure proposed by Mr Cregten. Again I am satisfied that the methodology adopted by Mr Cregten in settling upon unit value produces a fair, if conservative valuation of $354,369.

[158] The excess must be deducted from that. The excess was $1,000 in respect of "theft losses" occurring prior to 1 September 2004 and $2,500 in respect of such losses occurring after 1 September 2004. QBE had sought leave to amend its pleading immediately before trial to argue that Pegasus must prove each incident of theft, and then the excess must be applied to each such incident. I did not allow that amendment because the pre-existing pleading made no reference to such an application of the excess (in fact it made no explicit reference to the excess at all).

Since the theft was discovered and the claim made in the period covered by the second policy, I consider that the $2,500 excess should apply.

[159] QBE also argues that the warehouse fees withheld by Pegasus and any recovery from AHA should be deducted from this portion of Pegasus' claim. I deal with this argument later when I also consider AHA's set off claim.

Is Pegasus entitled to make a business interruption claim, and if so, for what amount?

[160] Pegasus makes a claim under the business interruption provisions of the insurance contract with QBE for loss of gross profit of $537,000. Clause 23 of the insurance contract is the operative clause and provides:

> **23.1.1 OPERATIVE CLAUSE**
>
> If during the Period of Insurance specified in the Schedule, any property or any part used or to be used by the Insured at the Premises, or as particularly provided herein, for the purpose of the Business be lost, destroyed or damaged by:
>
> 1) Such risks as are covered under Policy Section A Material Damage on the property;
>
> …..
>
> (All such loss, destruction, or damage hereinafter termed Damage) and the Business carried on by the Insured be in consequence interrupted or interfered with
>
> **THEN THE COMPANY WILL PAY TO THE INSURED** the amount of loss resulting from such interruption or interference in accordance with the provisions contained herein.
>
> …..

[161] Having found that Pegasus has proved a material loss for the purposes of the policy, it follows that it is entitled to make a business interruption claim for the amount of loss resulting from the interruption to its business caused by the theft of the stock.

Quantum of business interruption claim

[162] There are detailed provisions in the policy as to how any such loss is to be calculated. It was accepted by QBE that if Pegasus establishes material damage then it is entitled to indemnity for loss of gross profit due to reduction in turnover and increase in the "Cost of Working" less the sum saved during the indemnity period in respect of the "Insured Standing Charges" that cease or are reduced as a consequence of the damage. Gross profit is defined in the policy as:

> The amount by which –
>
> (a) the sum of the Turnover and the amount of the Closing Stock shall exceed;
>
> (b) the sum of the amount of the Opening Stock and the amount of the Uninsured Working Expenses.

"Rate of gross profit" is defined as the "rate of gross profit earned on the Turnover during the financial year immediately before the date of damage". The interpretation and application of these definitions was the subject of expert evidence from Mr Cregten for Pegasus and Mr Howell for QBE.

[163] Mr Harrison gave evidence that Pegasus suffered significant reduction in turnover as a result of its stock going missing. In particular he said that short deliveries and missed orders resulted in a loss of customer confidence and ultimately in some key customers stopping trading with Pegasus. Pegasus also had restricted access to its stock for the three month period from liquidation until Monarch had completed its stock count.

[164] Non-payment of the claim which Pegasus lodged with QBE and resulting cash constraints prevented Pegasus purchasing replacement stock in a timely fashion. Mr Harrison said that because of that, Pegasus was unable to complete some of the repeat orders that it had received from The Warehouse and other customers. That also caused some customers to cease doing business with Pegasus. In the 2005 year Pegasus dropped more than a million dollars in sales compared to the previous years. Farmers, who fined Pegasus $25,000 and refused to deal further with it, were normally a half a million dollar customer. Pegasus also lost Toyworld as a customer.

Pegasus has since been able to re-establish business with Toyworld, but not with Farmers.

[165] Mr Cregten gave evidence for Pegasus in relation to the business interruption claim. He said he had undertaken a calculation of gross profit lost in consequence of the damage. He accepted that in calculating the rate of gross profit he had not followed the strict policy definition, but had calculated it by reference to the Annual Financial Statements of Pegasus. But he said that if he had followed the strict policy definition, the rate of gross profit would have been higher.

[166] Mr Cregten's calculations utilised two methodologies: the first was a linear growth projection predictor on the three years prior to the insured event, and the second applied the annual average growth between 2005 and 2007 by using the midpoint of growth in those two years. Using these methods, he estimated standard turnover to be within a high range of $4,808,000 (based on linear growth) and a low of $4,452,000 (based on the two-year average), had no business interruption occurred. He calculated the loss in gross profit by multiplying the reduction in gross profits by the gross profit margin. Utilising the standard turnover range, he calculated the business interruption losses as between $537,000 and $412,000 plus GST.

[167] QBE relies on the evidence of its expert, Mr Roger Howell, a chartered accountant specialising in the adjustment of large business interruption claims for insurance companies. Mr Howell had a number of criticisms of Mr Cregten's calculations: He observed that in calculating the total material damage loss, Mr Cregten had not accounted for the $197,637.68 that Pegasus withheld from NZE in respect of outstanding warehousing fees. He said that it must be accounted for as a saving in overheads, or a reduction in creditors, as it represents warehousing fees that would otherwise have been paid by Pegasus. He therefore calculated the business interruption loss on the basis that if that sum was a saving by Pegasus, it should properly be deducted from the calculation of loss.

[168] Mr Howell did not consider that Mr Cregten had undertaken the investigative analysis necessary to satisfactorily conclude that there was a direct causal nexus

between the material damage and the business interruption. He was critical of the acceptance by Mr Cregten of Mr Harrison's evidence as to how the problems affected the business, including losing customers such as Farmers and Toyworld. He said that he would have expected there to be schedules of orders that had been unable to be filled, and correspondence from affected customers. He also said that Mr Cregten should have collected the following: evidence as to new competitors entering the same market as Pegasus; details around whether any of Pegasus' customers decided to deal directly with Pegasus' suppliers instead of through Pegasus; information as to Pegasus' pricing policy to assess whether that contributed to Pegasus losing market share because it was too expensive relative to competitors; and finally, exchange rate movements.

[169] Mr Howell said that he considered that the indemnity period commenced in June 2004 when the insured first discovered stock losses. In those circumstances the quantum of loss would in reality be considerably less, as mitigation efforts by the insured such as monthly stocktakes would be expected to significantly limit the losses.

[170] The next criticism that Mr Howell made was of Mr Cregten's reliance upon yearly sales figures. He thought he should have examined monthly sales figures for the two years prior to the event, and that the trend should have been considered over a two year rather than one year period.

[171] In Mr Howell's opinion, Mr Cregten had also failed to adequately account for savings in insured standing charges, which in his view included wages for Pegasus' employees recovered under the material damage claim. He said these were to be treated as a saving, and deducted from the claim. This is on the basis that the policy provides that the insured gross profit amount is to have deducted from it any standing charges that cease or are reduced by reason of the damages.

[172] Another significant difference between Mr Howell's and Mr Cregten's calculations was how they approached the deduction of uninsured working expenses from the claim. Mr Cregten accepted he did not follow the strict policy wording when calculating the rate of gross profit. Mr Howell said that he should have. In his

calculations he deducted the following uninsured working expenses in calculating gross profit: customs duty, foreign exchange gains and losses, freight and cartage, (inwards and outwards), packing and wrapping, royalties and bad debts.

[173] He also said, in evidence in chief, that he did not accept other adjustments that Mr Cregten has made to the accounts, but then on cross-examination, accepted that they were properly made.

[174] I deal with each of Mr Howell's criticisms in turn.

(a) Set-off

[175] Mr Cregten said that he had not deducted the $197,637.68 of warehouse fees withheld by Pegasus on the basis that he was instructed that he should not include it.

[176] However, as accepted by Mr Howell, if Pegasus must give credit for the warehouse fees it has withheld that need not be factored into the calculation for the business interruption claim. Pegasus is simply paying for the warehouse fees by having its obligation to pay them set off against NZE's obligation to recompense it for the value of the missing stock. As I come to later, I am satisfied that Pegasus cannot double recover, so its insurance recoveries must be net of the withheld warehouse fees.

(b) Proof of causation

[177] The most significant point made by Mr Howell is in terms of the nature of the inquiries made by Mr Cregten into the causal nexus between the material damage stock loss claim and the business interruption stock loss.

[178] Mr Cregten accepted under cross-examination that he had not undertaken any investigation to establish the precise cause of this loss in gross profit, but had assumed, on the basis of Mr Harrison's evidence, that the reduction in turnover was directly a result of the insured event. In particular, he did not speak to any of the customers whose business Pegasus claims to have lost through the disruption. But

he said that although turnover can reduce for many reasons, he considered the best evidence of the cause was to look at the graph of the company's gross profit that he had produced. That tracks a sharp reduction of gross profit in 2006 and then a subsequent recovery.

[179] Ultimately it is a question of fact for me as to whether I am satisfied that Pegasus suffered a disruption to its business by reason of the loss of a substantial portion of its stock which led to short deliveries and to a failure to supply. I accept Pegasus' submission that it is an available inference, indeed a strong inference, that a disruption in the supply chain caused by the missing stock would have led to a reduction in turnover and to damage to relations with Pegasus' customers.

[180] That the loss did in fact lead to a reduction in turnover is borne out by Mr Harrison's evidence about loss of customers and Mr Cregten's evidence as to the dip in gross profitability. Mr Howell suggested alternative explanations: new competition in the market place, pricing issues affecting market shares, or customers dealing directly with Pegasus' suppliers. But it is difficult to see any of these as a possible explanation given that in 2007 Pegasus' business sales climbed 8% over the sales in the period from 2005-2006. As to the possibility of the impact of foreign exchange, Mr Cregten took into account that the New Zealand dollar was reasonably stable against most currencies for the greater part of the year ended March 2006 and that the annual financial statements for 2006 reveal Pegasus making a $121,590 foreign exchange gain. Therefore exchange rate issues in that year could not have led to the reduction in turnover.

[181] One point not actively pursued by QBE or AHA was that some of the disruption to Pegasus' business would, as a matter of logic, have been caused by the liquidation of NZE, which led to reduced access for Pegasus to its product. Mr Harrison conceded as much when he listed limited access to the stock as one of the obstacles faced by Pegasus in the 2005/2006 year. This disruption operated independently from the insured cause of business disruption. There was evidence of this reduced access, and the claim allowed should reflect this.

(c) Obligation to mitigate

[182] Mr Howell proposes that Pegasus' loss should be reduced to reflect its failure to fulfil its obligation to mitigate its losses once it discovered stock was being stolen. He says that was June 2004, but from the evidence I am satisfied that Pegasus could not have known of the theft until February 2005. At that time it took appropriate steps to mitigate loss by working with NZE to identify the thieves and the extent of the theft. I make no adjustment for this.

(d) Time period for analysis

[183] Mr Howell said that the trend in turnover should have been considered on the basis of monthly sales figures for the two years prior to the loss. But in cross-examination he accepted that an annual period of analysis, rather than an analysis based on monthly figures, best eliminates seasonal trends. Further, there was nothing in the policy that required a two year rather than one year period of analysis. He confirmed that he had not calculated any alternative figure based on monthly figures so as to expose any deficiency in Mr Cregten's calculations. At the most, Mr Howell's evidence suggests a difference of opinion as to how best to approach the same task. It is not evidence that Mr Cregten's approach was wrong, or that the approach was not available under the terms of the policy.

(e) Standing charges

[184] The concern that Mr Howell raised was double recovery of staff costs since Pegasus makes a claim for staff costs for processing the indemnity claim. But there was no evidence to suggest that staff costs were reduced or could be reduced by reason of the loss, or that the indemnity claim relating to staff costs went toward the fixed portion of staff costs. Accordingly I make no adjustment for this.

(f) Uninsured working expenses

[185] The policy defines uninsured working expenses (for the purposes of the gross profit calculation) as follows:

> (a) All purchases less discounts received;
>
> (b) Royalties being that portion of such cost directly variable with Turnover. It is understood and agreed that fixed royalty payment (i.e. not variable with Turnover) are an Insured Expense and therefore do not form part of the Uninsured Working Expenses;
>
> (c) Cartage and freight outwards and other distribution expenses including Marine Insurance if undertaken by independent operators unless under contract;
>
> (d) Packing material;
>
> (e) Waste disposal;
>
> (f) Consumable stores;
>
> (g) Discounts allowed;
>
> (h) Factoring costs;
>
> (i) Bad debts and legal and other expenses pertaining thereto;
>
> (j) Others as per the schedule.

[186] Under cross-examination Mr Howell accepted that there was nothing in the policy to require the deduction of cartage and freight inwards, customs duties or foreign exchange gains or losses. Although the policy does not include these in the definition of uninsured working expenses, Mr Howell said he thought that inwards freight, customs and duties paid and foreign exchange claims and losses were all costs of purchase and should be included.

[187] But there is no reference in the definition to "costs of purchase", the reference is to "purchases". Some of the itemised costs are costs naturally associated with the cost of purchase such as packing material, yet are separately listed. Both of these aspects of the drafting of the clause are inconsistent with the interpretation Mr Howell suggests. I accept Pegasus' argument therefore that the items that Mr Howell mentions that do not appear on the list should not be included. But listed items should be. As to royalties, Mr Cregten's evidence was that some royalties

should be excluded from the calculation because they were fixed costs, rather than variable with turnover. This approach is consistent with the policy definition. Mr Cregten's calculations already included a figure for customs duty not required to be included by the policy and a larger figure for freight costs than the policy strictly required. But he included nothing for packing or bad debts.

[188] Mr Cregten's evidence was that if he followed the strict policy wording, rather than his approach of utilising Pegasus' annual financial statements, he arrived at a much higher gross profit. This approach produced a gross profit for insurance purposes of $1,622,794 compared to $1,501,885 in his original calculations. Therefore, applying the strict policy wording, the new calculation would produce a figure at the upper end of the range proposed by Mr Cregten for this claim (in fact, slightly outside the upper end).

(g) Conclusion

[189] Ultimately I am not persuaded by Mr Howell's evidence that the range suggested by Mr Cregten is a miscalculation of Pegasus' entitlement under the business interruption insurance. Pegasus has claimed $537,334, an amount at the high end of Mr Cregten's range, but I consider that a lower figure of $412,588 should be taken. This is a conservative figure, but that is appropriate since the profit for the year, irrespective of theft, would likely have been reduced to some extent due to the liquidation of NZE. This is a fairly rough measure of business interruption, but that is inevitable given the nature of the assessment the policy itself calls for.

What claim expenses is Pegasus entitled to recover?

[190] Pursuant to clause 21.1.8 of the insurance contract, because Pegasus has a right to claim indemnity under the contract, it is also entitled to claim the costs associated with preparing and making a claim under the material damage provisions of the contract. Clause 21.1.8 provides:

> The costs and expenses as may be reasonably incurred by the Insured for the assessment or preparation of claims made under this Policy.

> Salaries, wages and overheads of the Insured's employees shall be deemed to be part of such costs and expenses.

Clause 23.1.3, sub-clause 8, extends this to costs and expenses reasonably incurred for the negotiation, certification and justification of claims.

[191] Pegasus claims the following costs and expenses which it says it has incurred in quantifying and pursuing its claim for indemnity:

a) $21,977 plus GST in relation to Monarch completing the independent count of Pegasus' stock.

b) $48,814 plus GST in relation to Mr Cregten and his staff at Corporate Finance Ltd carrying out an independent verification of the missing stock.

c) $25,707 plus GST in relation to Bell Gully assisting in assessing and preparing the missing stock claim.

d) $9,578 plus GST in relation to private investigators engaged by Pegasus to investigate the theft of stock.

e) Salaries, wages and overhead costs of Pegasus' employees totalling $5,500 in relation to time spent working on the assessment and preparation of the missing stock claim.

[192] Mr Harrison's evidence was that these were all costs incurred by Pegasus in preparing the missing stock claim. QBE accepts the salary or private investigator's costs as recoverable if there is a valid claim for material damage, but challenges Pegasus' right to indemnity for the Monarch, Corporate Finance Ltd, and Bell Gully fees.

[193] In relation to Monarch's costs, QBE says that the costs would have been incurred by Pegasus regardless of the claim made against QBE, as this count was a pre-requisite to entering into an agreement with Monarch. Mr Courtney, Monarch's former General Manager, gave evidence for the plaintiff. He said that a full count

was stipulated by Monarch as a condition of taking on the warehousing contract. However, Pegasus relies on his further evidence that, at Pegasus' request, Monarch did a recount after the initial count and that this second count was so that it would have an independent count of its stock to enable it to prepare and assess its missing stock claim.

[194] In closing, Pegasus accepted that it must reduce its claim in respect of the Monarch count; it now seeks to recover only the costs of the second count. There is, however, no evidence as to which of the invoices (there are several) relate to the second count.

[195] As a matter of simple logic, the initial count would be expected to be more expensive than the recount, since Mr Courtney's evidence was that during that first count the stock was put into appropriate order. But Pegasus claims that the second count should have a cost of $16,745.54 allocated to it (well over half of the amount charged for the stock counts together). In terms of the known chronology of events it seems more likely than not that the July invoices relate to the second count. Pegasus should therefore be entitled to damages for the amount of those invoices totalling $7,962 GST exclusive.

[196] QBE disputes Pegasus' claims to costs in relation to Corporate Finance Ltd because it says that Corporate Finance was not engaged until after proceedings were issued, and that those costs are not then part of the usual costs associated with the preparation of claims. It must be correct that Mr Cregten's engagement was for the purposes of this proceeding rather than the preparation of a claim under the policy. By the time these costs were incurred the claim had been rejected, so that they were not incurred in preparing, negotiating or justifying the claim, but rather in prosecuting the breach of contract. These costs are better addressed under the costs and disbursements regime of the High Court Rules.

[197] In relation to Bell Gully's costs, QBE argues that these cannot all relate to preparation of the claim as some of the invoices were rendered on different file numbers. Mr Harrison's evidence was that these costs were associated with obtaining legal assistance to formulate the indemnity claim presented to QBE. No

evidence was put forward to suggest otherwise, and the use of different file numbers is not evidence that the work does not relate to the claim. These costs are then claimable.

[198] Pegasus is therefore entitled to indemnity for the following expenses:

a) $7,962 for Monarch fees;

b) $25,707 for Bell Gully fees;

c) $9,578 for private investigators; and

d) $5,500 for salaries.

[199] Pegasus also claims $84,118 in relation to services provided by Corporate Finance, quantifying and substantiating the business interruption claim. Mr Harrison's evidence was that those costs related to quantifying the business interruption claim and consequential losses. But the claim was rejected by QBE before it was quantified. Again the costs are properly regarded as disbursements to be dealt with within the regime created by the High Court Rules. (I note in passing that there is in any event a $10,000 limit for claim preparation costs for a business interruption claim).

What consequential losses is Pegasus entitled to recover?

[200] In addition to the claim for indemnity, Pegasus seeks damages for losses it says it would not have suffered had QBE indemnified it for the missing stock, the business interruption claim and the costs of preparing the missing stock claim in accordance with the insurance policy.

[201] The relevant principles are not in dispute. In New Zealand, the extent to which an insured can recover monetary compensation for consequential losses is determined on ordinary contractual principles. In *State Insurance Ltd v Cedenco Foods Ltd* [1998] BCL 1051, the Court said:

> [T]he financial significance for an insured of late payment is capable of being compensated on ordinary principles of contractual damages, if qualifying loss is established.

[202] The general contractual principle is that if a plaintiff has suffered damage that is not too remote, it must, so far as money can do so, be restored to the position it would have been in had the breach not occurred (*Robinson v Harman* (1848) 1 Exch 850).

[203] The test for remoteness of damage is well known and is articulated in *Hadley v Baxindale* (1854) 9 Exch 341 at 354-355 which prescribes that, to be recoverable, loss or expense:

> Should be such as may fairly and reasonably be considered either arising naturally, i.e., according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it.'

[204] In *Clarkson v Whangamata Metal Supplies Ltd* [2008] 3 NZLR 31, 38 the Court of Appeal expressed approval for comments by various members of the House of Lords in *Sempra Metals Ltd v Inland Revenue Commissioners* [2007] 3 WLR 354, to the effect that the two limb test (as it has come to be described) in *Hadley v Baxendale* is simply a practical expression of a single principle that parties should be liable only for damages that were, or ought to have been, within their contemplation at the time they contracted.

[205] Pegasus says that the following are costs which it has incurred as a result of QBE's failure to pay its claim and which were within the contemplation of the parties (or were reasonably foreseeable) at the time they entered into the contract of insurance:

a) Legal costs associated with legal proceedings to enforce the indemnity totalling $175,595 plus GST.

b) Accounting costs associated with the preparation of accounts and services provided by Pegasus' accountants in relation to Pegasus' claims totalling $15,000 plus GST.

c) Licence fees totalling $79,760 plus GST. Pegasus alleges that it was contractually obliged to pay these fees because it did not have sufficient funds to buy and sell the quantities of merchandise it had agreed to under three licensing agreements.

d) Storage and detention fees Pegasus had to pay to its warehouse and logistics companies because it could not make payment of invoiced amounts on time, totalling $162,052 plus GST.

e) Lock Finance's costs totalling $212,795 plus GST. Pegasus says it had to transfer its funding requirements to Lock Finance because of the failure of QBE to indemnify it. Pegasus had to indemnify Lock Finance for its costs incurred in overseeing and reviewing Pegasus' business.

f) Salaries and wages incurred in respect of claims against both defendants totalling $20,817 plus GST.

g) Private investigation costs associated with collecting further evidence in relation to the theft of Pegasus' stock totalling $36,525 plus GST.

h) Additional interest on refinancing totalling $933,383, as a result of having to fund the full amount of the missing stock and business interruption claims, and continuing at a rate of $1,250 per day.

[206] Although each of these heads of claim needs to be addressed in turn, a prior question is the date upon which QBE became contractually obliged to meet these claims. If the loss claimed by Pegasus under this head was incurred prior to QBE's breach, then QBE's breach is unlikely to have caused the loss.

[207] I was not referred to any provision in the contract of insurance governing when a claim must be paid. There is, however, a positive obligation on Pegasus to provide particulars of the claim, and to give to QBE all proof and information as it reasonably requires (clause 21.4.2). It is clear that QBE could not be obliged to

make payment of the claim until such time as the amount recoverable has been ascertained (*Randall v Lithgow* (1884) 12 QBD 525). And an insurer is entitled to investigate any claim presented to it and may seek the assistance of professional advisers in doing so. The main obligation on an insurer is to satisfy, within a reasonable time, a claim that falls within the scope of the policy. An insurer will be in breach of this duty if it acts capriciously or unreasonably in relation to the claim (Kelly & Ball, *Principles of Insurance Law*, paras 8.0110 and 8.0170).

[208] To determine when the amount recoverable has, or ought to have, been ascertained it is necessary to consider how QBE processed the claims.

[209] Mr Mike Vincent, Deputy Claims Manager at QBE, gave evidence in relation to QBE's handling of this claim. Pegasus' broker notified QBE of the claim on about 3 May 2005, and QBE appointed a loss assessor for the claim that day; one Mr McIver. On 5 May Pegasus lodged its claim for missing stock. Pegasus said that it was believed the stock had been taken by a ring of 16 NZE employees who were systematically stealing stock, and who had been captured on video.

[210] Mr McIver reported back to QBE on 6 May 2005. He said he had been told that Pegasus had lodged the claim as a protective measure only as it was seeking reimbursement from NZE. He raised concerns that the claim had been notified late, because on its claim form Pegasus said that it first became aware of stock loss in July 2004. In his view, Pegasus should have notified the claim then. He recommended the claim be declined because of late notification, in reliance on exclusion clause 21.3.5. He suggested a further ground that Pegasus had not taken reasonable precautions to prevent loss.

[211] Mr Vincent said that notwithstanding Mr McIver's recommendation, he decided to investigate the claim further. He was concerned to see if theft had in fact occurred, as if it had, he said he would have considered covering at least part of the claim. But because of the grounds for declinature suggested by Mr McIver, Mr Vincent involved QBE's solicitors.

[212] On 9 May 2005 QBE acknowledged receipt of the claim. Pegasus' broker told QBE that Pegasus was proceeding with the claim and that the stock was to be counted over the next few days by an independent body. Mr Harrison would arrange for QBE to be able to check the count process if it so wished. QBE declined the invitation, as it was satisfied with the independence of the process.

[213] Through May, June and July 2005 Mr McIver sought information from Pegasus, and Pegasus promptly provided it. Based on that information, QBE decided not to decline the claim for late notification. It considered that any non-disclosure was probably innocent, and QBE had probably not been prejudiced. On 6 July 2005 Mr McIver emailed Pegasus asking for the value of its stock unaccounted for at the time of transfer of the stock to Monarch, so that Pegasus' claim could be processed. Mr Harrison replied that Pegasus was waiting for final verification from the new logistics company (Monarch) and that he expected to be able to provide the information in two to three weeks.

[214] Mr Vincent said that at this time QBE felt it did not have sufficient information to be satisfied that the stock loss was attributable to theft, or know what the true level of that stock loss was.

[215] In early August QBE's solicitors sought information from the liquidator as to Pegasus' stock that might have been stolen, staff thefts, who was involved, and what was known to have been stolen. On 1 August 2005 QBE's solicitors wrote to Pegasus' broker referring to the inventory exclusion clause and advising:

> Our client requires confirmation that the loss claimed is for stolen goods before it is able to indemnify Pegasus. We understand that AHA has engaged Thomas Pasley & Associates Limited as loss adjusters, and it may that [sic] they will be able to assist in that regard. We have written to NZE about this. In addition, our client requires confirmation that the perpetrators of the theft were employed by NZE at all relevant times and operated in the warehouse where Pegasus' goods were stored together with details of the thefts which have been admitted. We have also made inquiries of NZE about this.

[216] On 4 August the liquidators replied to QBE's earlier letter. They said they had the Icon stock sheets and were evaluating the stock count. AHA required that the count be compared with NZE's perpetual inventory records, reconciled to any

other stock count performed by Monarch and compared to the perpetual records of Pegasus so far as possible. The liquidators said that to do this properly they needed to give Pegasus the Icon stock sheets, but AHA was refusing Pegasus access.

[217] On 3 October 2005 Pegasus' solicitors wrote to QBE's solicitors quantifying the stock loss at between $450,000 and $500,000. Also in October the liquidators wrote to QBE advising that they had sought information from Pegasus, but had yet to receive it. From the chain of correspondence it seems that Pegasus did provide the liquidators with some information after that date, but the liquidators were not happy with the form it was in.

[218] On 20 December 2005 Pegasus' solicitor wrote to QBE's solicitors, enclosing spreadsheets detailing the various components of its claim for lost stock. The letter quantified the claim at $569,029.08. Pegasus said that the liquidators would not identify the alleged perpetrators but had confirmed that some of them were NZE staff and that they had admitted their guilt. The liquidators had referred the allegations to the police. Pegasus was trying to get information from the police as to progress with the investigation. The liquidators had told Pegasus that they believed all of the missing stock was stolen by NZE's employees.

[219] Mr Vincent was not satisfied with the information provided. He had expected information as to the thefts admitted and details of the charges laid against staff. In February 2006 QBE's solicitors wrote to Pegasus' solicitors, saying that QBE did not have enough information to satisfy it that the missing stock was attributable to theft rather than administrative error. In March, Pegasus' solicitors replied asking for clarification of what further information QBE wanted from Pegasus. QBE's solicitor responded, saying it required verification that the missing stock was due to theft, rather than accounting or clerical errors. No particular information was requested, but the solicitors recorded their understanding that Pegasus was making enquiries of NZE "in this regard".

[220] In April 2006 QBE said to Pegasus that it would appoint its own investigator and possibly a specialist accountant to further investigate the claim. In the interim, Mr Vincent proposed a progress payment of $100,000 in good faith to assist Pegasus

with its financial circumstances. The offer was made on the proviso that it was to be repaid if it was established there was no valid claim. QBE then appointed its own investigator, but before he was able to report back, QBE withdrew its offer of part payment of the claim.

[221] Mr Vincent was cross-examined about the background to QBE's withdrawal. He said that he was told to withdraw the offer by Mr Ross Chapman, the Chief Executive of QBE. Mr Chapman also gave evidence. He said he was phoned by the broker for NZE, and made a file note of the conversation. He had little recollection of the conversation independent of that note. The note recorded that Mr Cameron told him that "Tom Pasley" had investigated for NZE's insurers; that Pegasus owed NZE $300,000 in storage fees; that although there had been some staff theft, most of the stock had been located in one or other of the warehouses; and that "there was no way thousands of dollars of stock was stolen". Mr Cameron suggested that Mr Chapman call the liquidator, Mr Hoole. The note concludes "possible NZ Express withholding stock against outstanding storage fees".

[222] Mr Chapman did not contact the liquidator. Instead, he instructed Mr Vincent to withdraw the offer of part payment pending further investigation of the information he had received. But he did not direct anyone to investigate the information he had received from the broker. Mr Chapman and Mr Vincent were both cross-examined in relation to the file note. During the course of that cross-examination it emerged that QBE had claimed legal privilege for the file note so that it was not disclosed to Pegasus during the discovery phase of this proceeding, although of course there was no basis for such a claim. Subsequently Pegasus issued interrogatories to QBE seeking the reason for the change in the decision to make the progress payment. QBE refused to answer the interrogatories. Mr Chapman said he did not know of the interrogatories but agreed he had undertaken to Mr Cameron not to disclose his name and that he had also instructed Mr Vincent that Mr Cameron's name was not to be disclosed.

[223] Although the offer had been withdrawn, QBE took no steps to appoint an investigating accountant to perform the type of task ultimately performed by Mr Cregten, a review of Pegasus' perpetual system. Nor, it seems, did it engage its

loss adjuster in assessing the claim at this point. Mr Vincent said QBE continued to wait for the Icon stock count. He said he preferred the liquidators' count over the Monarch count because the liquidators' was an independent count, whereas the Monarch count was not. This was not a valid basis for differentiating between the counts, as the liquidators' count was in no sense independent.

[224] In May QBE received Pegasus' investigator's report recording the investigator's opinion that the evidence was compelling that the stock losses had been caused, to a substantial degree, by theft committed by NZE staff. That report was referred to QBE's investigator for review. Following this, Pegasus agreed to provide information to assist the liquidator in completing a review of NZE stock records. QBE agreed with the liquidator that it would meet part of the liquidator's costs on that review.

[225] In June 2006 Pegasus inquired of the broker how it should progress a claim under the business interruption section of its policy. This query was passed on to Mr Vincent, who responded that a material damage claim would need to be accepted before QBE could address the business interruption claim. Pegasus did not therefore lodge a fully quantified business interruption claim.

[226] In July 2006 QBE's own investigator reported back that there was no evidence of major or organised stock theft by NZE employees. In early November Pegasus issued these proceedings. In late November the liquidators reported back their finding that there had been no stock loss, a finding reliant on the Icon count. The liquidators said that the Icon count showed that there was stock on hand of $1.7 million. Pegasus' inventory showed there should be stock on hand of $1.2 million. This view was of course dependent on Mr Kane's analysis of the Icon count, which was flawed.

[227] QBE finally declined Pegasus' claim in December of 2006. It gave as its reasons the liquidators' finding that there was no physical loss of stock, and that any shortages were unexplained disappearances and were in any event shortages revealed on stocktake. QBE said that those losses were therefore covered by the inventory

exclusion clause. Finally, any stock loss had already been compensated for by the set-off that Pegasus had asserted as against NZE.

[228] What is apparent from this narrative is that Pegasus did not fully particularise its claim until December 2005, and did not provide its investigator's report until May 2006 to substantiate its claim that theft was responsible for the loss. This was a complex claim, and QBE had to work through the liquidators to gain access to some critical information. Mr Vincent said that QBE had been diligently investigating the claim throughout and I agree that initially QBE did act promptly. But by May 2006 when it received Pegasus' investigator's report on the evidence of theft, it had received all information that Pegasus was able to provide, and had had ample time to make its own inquiries. QBE had the details of Pegasus' inventory, the results of the Monarch count, and Pegasus' investigator's report. It had not requested any particular information from Pegasus since July of the previous year. I consider that it should have accepted the claim at least by 31 May 2006. That allows a further month for QBE to collate the material it had, following the receipt of Pegasus' investigator's report.

[229] As to the business interruption claim, QBE was not in breach of its obligation to indemnify Pegasus in this regard until it could reasonably have been expected to have accepted the material damage claim and quantify losses arising from the consequent interruption to Pegasus' business. Having regard to the nature of the inquiry required to quantify business interruption and my finding that QBE ought to have accepted the material damage claim by 31 May 2006, I consider that QBE was in breach of its obligation to indemnify for business interruption from 31 August 2006. Three months was ample time for the quantification exercise to be carried out.

[230] I recognise that QBE did not receive a completed business interruption claim from Pegasus before December 2006, but this was to be expected where declinature of the material damage claim appeared likely (which it did from the time that the offer of part payment was withdrawn).

[231] I have also given consideration to the fact that Pegasus agreed to the liquidators undertaking further investigations (which were not completed until

November 2006), and in particular whether this postpones the date by which QBE should reasonably have accepted the claim. Since QBE had not accepted the claim at the time it made the request of Pegasus and had proposed the liquidators' investigation as a way forward, Pegasus had little choice but to agree. It was not reasonable for QBE to delay the processing of the claim to wait for the liquidators' report. Given the extent of the information QBE had access to, it could and should have settled on a more timely method of investigation.

[232] I have also weighed the fact that Pegasus' claim for indemnity was for a greater amount than it has finally been successful in recovering. The reduction in claim arises from Mr Cregten's utilisation of a lower cost price than the system generated price, from his elimination from the claim of items subsequently found through the audit he undertook and from the application of the provisions of the policy. QBE could have dealt with concerns as to the precise quantum it was obliged to pay by utilising the procedure contained in the policy for part payments. This allows the insurer to make progress payments to the insured where a claim has been accepted, whilst the insurer's assessor or loss adjuster is adjusting the claim (clause 21.2.20). If it subsequently transpires that the adjusted claim was less than had already been paid by Pegasus then Pegasus would have had to repay the balance.

[233] It is now convenient to address each head of claim for consequential losses.

Legal costs associated with this proceeding

[234] Mr Harrison's evidence was that as a consequence of the non-acceptance of its claim, Pegasus incurred further significant legal costs in order to enforce its entitlement to indemnity. Pegasus argues that the legal costs of prosecuting a claim to indemnity should be recoverable as consequential losses in that they are damages that were or should have been within the parties' contemplation at the time the contract was formed. But I consider that they are a step further removed than that - they are losses flowing from the steps taken to force QBE to remedy the breach, rather than from the breach itself. A similar argument to that advanced by Pegasus was made and rejected in *Herbison v Papakura Video Ltd (No 2)* [1987] 2 NZLR 720. In that case a claim was made for accounting and legal fees incurred in

connection with litigation following a breach of contract. In analysing this claim Henry J said at 735:

> The claim is not really one for wasted expenses in the sense sometimes used as a head of damage, as these are not expenses rendered futile by the breach. (McGregor on Damages (14th ed, 1980) § 42). Neither do they come under the head of recovery relating to expenses caused by breach, although of course they could generally be so described. They are expenses incurred in the course of the purchaser enforcing an entitlement to damages as against the vendor, and do not form part of the compensatable loss as a head of damage. To hold otherwise would make solicitor/client costs recoverable as damages for breach of contract as a matter of principle (being a natural consequence reasonably expected to flow from the breach). Such is not the law as I understand it. This head of claim therefore fails.

[235] I agree with this reasoning.

Accounting costs

[236] Mr Harrison gave evidence that his accountants, BDO Spicers had to attend to additional matters for Pegasus by reason of the non-payment of the indemnity claim. In particular they have had to attend meetings and discussions regarding the ongoing litigation, make various entries in Pegasus' financial statements, expand the notes of financial statements to explain entries and attend to various queries regarding accounting treatment from Corporate Finance. They have issued a number of invoices over the relevant period, but these relate to all attendances for Pegasus, some of which were of a general ongoing accounting and auditing nature. Mr Harrison gave evidence that he estimated the proportion of those invoices that related to the additional attendances was $15,000 (excluding GST). That estimate was not challenged.

[237] The other explanations as to the attendances are vague. As I understand it they are all designed to capture the additional cost incurred by Pegasus because its accountants had to reflect the contingent nature of its claim in its accounts. QBE has not advanced any particular argument in relation to these costs, other than its blanket denial that Pegasus is entitled to indemnity, but it has denied liability for them in its statement of defence. With all of these costs, I consider they are too remote, in that

they would not have been within the reasonable contemplation of the parties, at the time they contracted, as the probable result of a breach.

Licensing fees

[238] Pegasus' statement of claim details three Licence Agreements to which Pegasus was party: the "Spongebob" Licence dated 7 July 2004, the "Dora" Licence dated 1 November 2005 and the "Ford" Licence dated 15 July 2005. In respect of the Spongebob Licence, Pegasus guaranteed to pay a minimum royalty payment to the Licensor of $10,000 plus GST. Pursuant to the Dora Licence it guaranteed to pay a minimum royalty payment of $30,000 plus GST. Finally, in respect of the Ford Licence it guaranteed to pay a minimum royalty payment to Ford of $56,800 plus GST. Pegasus pleads that it has paid all the minimum payments for the Spongebob and Dora Licences, and $39,760 plus GST toward the Ford minimum payments.

[239] In his evidence, Mr Harrison said that because of QBE's failure to indemnify, Pegasus did not have sufficient funds to buy and sell the quantities of merchandise they had agreed to under three licensing agreements, and was obliged to make the minimum payments without having made any sales of the branded licensed products. Pegasus refers to the decisions in *State Insurance Ltd v Cedenco* and *New Zealand Insurance Company v Harris* [1990] 1 NZLR 10, 17 which it says shows that the Courts take the view that an insurer will be taken to know that the insured will face financial difficulties if the claim is not paid within a reasonable time. It says that the incurring of the minimum royalties was a natural result of these financial difficulties.

[240] QBE says that the loss cannot be a consequence of any breach by it because the Dora and Ford licenses were entered into by Pegasus after the commencement of the proceeding. But Pegasus argues that it is not the timing of the contracts that is at issue, but rather Pegasus' inability to perform the contracts as a result of QBE's breach. It says that Pegasus was entitled to assume that QBE would pay its claims within a reasonable amount of time and had it done so, Pegasus would have been in a position to make and to sell the products contemplated under the license agreement.

In that case the guaranteed royalty payments paid under the license agreements would not have been wasted.

[241] Pegasus faces a number of difficulties with this aspect of its claim. There is no detail as to the date of the payments made to the licensor. In terms of the Spongebob licence Pegasus was contractually obliged to pay the total royalty due under the licence by 20 February 2005. This was in terms of a licence which ran from 1 July 2004 through to 30 June 2006. If Pegasus' complaint is that it did not sell enough product to fully recover the largely up front payment because of the lack of capital, it has not said so. Mr Harrison simply asserts that no product was able to be bought and sold. If no product was able to be bought and sold, it seems that must be for reasons other than breach of contract by QBE, since QBE was not in breach until the end of the licence period.

[242] The Ford Agreement had a two year term of March 2005 through to March 2007. Although only part of the term falls after the date by which QBE should reasonably have paid the claim, again Mr Harrison says that no product was bought or sold because of the financial difficulty caused by the breach. The Dora Licence was not entered into until November 2005, and ran through until the end of October 2007. Again Mr Harrison says no product was sold. It is not clear from his evidence why Pegasus was not able to buy and sell any product. He provides no detail beyond saying that it was the result of QBE's failure to indemnify. But on Mr Harrison's own evidence Pegasus was able to secure additional funding lines, and indeed Pegasus has claimed the cost to it of that. Pegasus has simply failed to provide adequate evidence to show that this was a loss flowing from the breach of contract. More than mere assertion is required.

Storage and detention fees

[243] Mr Harrison's evidence was that Pegasus incurred detention and storage charges totalling $172,329 through Mondiale Freight Services Ltd and Ocean Bridge Ltd. He said that it was charged these detention charges as a result of its failure to pay freight charges incurred when importing stock through Mondiale and Ocean Bridge. And that if QBE had indemnified Pegasus for the missing stock, the costs

and expenses and the business interruption claim, Pegasus would have been able to pay the freight charges and the detention charges would not have been incurred. These detention charges were incurred between 2 November 2006 and 12 April 2007.

[244] QBE says that the invoices include costs of dispatching orders which are a normal business expense. It also says that there is no explanation from the plaintiff as to why, with replacement funding in place from 2005, it was unable to pay for freight charges when importing stock.

[245] I accept that financial difficulties caused by the non-payment of Pegasus' claim would have caused a shortage in working capital from time to time and that it was reasonably foreseeable that a failure to indemnify on a large stock loss claim would have this effect. It is possible that such a disruption in the level of stock for Pegasus would lead to a disruption in working capital and that occasionally facility limits would mean that stock could not be collected on time because of an inability to pay. But this is merely speculation because again insufficient evidence has been put before the Court.

[246] In any case, I consider payment of detention charges cannot be categorised as the type of loss that would have been within the reasonable contemplation of the parties. Pegasus has made multiple claims for detention and storage charges, which strongly suggests that the loss can be attributed more readily to decision making on the part of Pegasus as to the timing of these importations, than to an ongoing lack of working capital. These losses are then too remote to be recoverable.

Additional financing costs

[247] Mr Harrison's evidence was that as a condition of finance, Lock Finance required oversight of Pegasus' business by an advisory board and the engaging of a general manager and external consultants to review monthly trading results and business plans. Pegasus says that these costs naturally flowed from Pegasus' financial position after denial of its claim. Pegasus claims reimbursement of invoices paid by it for solicitors and various management consultants whom Lock

Finance stipulated must be involved in the documentation of arrangements with Pegasus and in the oversight of its business.

[248] As Mr Harrison conceded, Pegasus had refinanced with Lock Finance well before QBE could reasonably have been expected to indemnify Pegasus. Pegasus refinanced with Lock Finance in August 2005. For this reason, these costs cannot be said to flow from the breach. In any case I consider these costs are too remote to be properly recoverable from QBE. Lock Finance stipulated for a very high degree of management input into the affairs of Pegasus, all at Pegasus' expense. I refrain from comment on it further than to say that these are the requirements of a particular lender, and cannot have been within the reasonable contemplation of the parties when they entered into the contract of insurance.

Salaries and wages incurred in respect of claim

[249] Mr Harrison's evidence was that due to the non-payment of the claims, Pegasus incurred additional staffing costs and overheads totalling $14,266 in respect of the claims against QBE as follows:

a) 233 hours of his own time at $42.79 totalling $9,991.

b) 82 hours of Lois Harrison's time at $18.27 totalling $1,498.

c) 178.5 hours of Cameron Rowland (accountant) time at $18 totalling $2,776.

[250] QBE says that these are really costs incurred in the litigation, and should not be recoverable as consequential losses. When regard is had to the time sheets prepared, it is apparent that this is indeed the case, although there is also some work involved in dealing with the company's financiers. Again I consider that these costs do not fall under a recoverable head of damage; they are costs associated with the enforcement of QBE's contractual obligations.

Private investigation costs

[251] Mr Harrison said that Pegasus hired two private investigation firms to investigate the theft of its stock, and that they rendered fees totalling $36,525 plus GST. Although Mr Harrison refers to invoices for these fees, some of the invoices at least relate to private investigators' fees already addressed under the head 'claim preparation', for which Pegasus is entitled to indemnity. There is no detail of the nature of the attendances. Since they are separated out from the indemnity claim for costs, I infer they are costs associated with the litigation. Again, if recoverable at all, they are to be recovered under the costs and disbursements regime created by the High Court Rules.

Additional interest on refinancing

[252] A very significant proportion of Pegasus' claim is for compound interest in the sum of $933,383. It says that interest has accrued because it had to fund the amount of the missing stock claim, the business interruption claim and the costs incurred by Pegasus in making claims for the period from 3 September 2005 to the year ending 31 March 2009 itself. A claim is also made for interest continuing at a rate of $1,250 per day.

[253] QBE responds that it is fatal to Pegasus' claim to interest, as pleaded, that it had had to arrange the alternative facility prior to the date on which QBE could reasonably have been expected to pay the claim.

[254] I agree that QBE can have no liability for interest prior to the date that it was in breach of contract in failing to indemnify Pegasus. In respect of the material damage claim it was in breach by 31 May 2006 and in respect of the business interruption claim by 31 August 2006. Pegasus cannot be entitled to interest earlier than those dates.

[255] But it can claim interest (including compound interest) for breach of contract, subject to the usual rules of causation, proof of loss, remoteness of damage and mitigation (*Clarkson v Whangamata Metal Supplies Ltd* at [49]). The reason and

basis upon which interest should be recoverable as damages was succinctly put by Lord Nicholls in *Sempra Metals Ltd v Inland Revenue Commissioners* [2007] UKHL 657, 684:

> Those who default on a contractual obligation to pay money are not possessed of some special immunity in respect of losses caused thereby. To be recoverable the losses suffered by a claimant must satisfy the usual remoteness tests. The losses must have been reasonably foreseeable at the time of the contract as liable to result from the breach. But, subject to satisfying the usual damages criteria, in principle these losses are recoverable as damages for breach of contract. This is so even if the losses consist of a liability to pay borrowing costs incurred as a result of the late payment, as happened in *Wadsworth v Lyall* [1981] 2 All ER 401, [1981] 1 WLR 598. And this is so irrespective of whether the borrowing costs comprise simple interest or compound interest.

[256] The fact that the refinancing occurred prior to the breaches creates no obstacle to this part of Pegasus' claim. Although there was in the past a rule that interest could not be recovered as damages for a breach of contract, that rule has been steadily eroded over time and can no longer be regarded as part of the law. A party that proves a breach of contract can claim for interest.

[257] I consider that it was within the reasonable contemplation of the parties to the contract that a failure to indemnify Pegasus in accordance with the terms of the contract of insurance, would require Pegasus to fund the shortfall in its circulating capital that the loss of stock caused. Since Pegasus was, to the knowledge of QBE, a trading entity, the impact of a failure to pay would be either to remove the ability of Pegasus to use the funds to earn a return, or where, as here, there was a resultant shortfall, to cause Pegasus to borrow the funds. The insurance policy did, after all, insure for (amongst other things) loss of capital items, and for business losses flowing from the loss of those items. In apparent recognition of the hardship such loss would cause, the policy provided a mechanism whereby payments to the insured could be made before a claim had been accepted.

[258] Pegasus has both pleaded a claim for compound interest, and proved the relevant compound interest rates, using Lock Finance's average short-term rates, which were those paid by Pegasus. Mr Cregten provides two different calculations of the additional interest involved as a result of the increased borrowings, based on when the expenditure was made or when the funds could reasonably have been

expected to be received. These calculations will need to be revisited in the light of this judgment, and should utilise Lock's average short term rates, and be prepared on the basis of when the expenditure was actually incurred. However, this is subject to the proviso that the amount on which the calculation is to be based is the lesser figure of expenditure incurred or the unpaid indemnity amount (from 31 May 2006 for material damage and 31 August 2006 for business interruption). This proviso is necessary to prevent Pegasus recovering more than the loss it has proved.

Good faith cause of action

[259] In its statement of claim, Pegasus alleges that QBE owed it a duty of utmost good faith to respond to its claims under the contract of insurance both in respect of the missing stock, and the business interruption claim. Pegasus argues that the duty comprises an obligation to respond to Pegasus' claims within a reasonable time. Submissions did not clarify what Pegasus says is the precise content of the duty, but the breaches particularised in the statement of claim imply other aspects to the duty alleged.

[260] Pegasus says, not only that QBE failed to respond, but also that it failed to investigate and pre-determined the missing stock claim, failed to tell Pegasus why it reversed its decision to make a provisional payment in respect of the missing stock claim, and requested Pegasus' insurance broker conceal details of its investigation from Pegasus.

[261] During closing submissions, Pegasus added a further particular of breach. It alleged that QBE had breached its duty of good faith by reason of steps taken in the litigation in the previous month. In particular, Pegasus argued that a very late application for security for costs was made for tactical reasons. Pegasus says that the application was made in circumstances where QBE was aware that if security for costs were ordered, Pegasus had no ability to pay them.

[262] It is also argued that a late application to amend QBE's statement of defence to add in an allegation of fraud was made to derail the hearing. The allegation of fraud, if allowed to be pursued, would have required Pegasus' solicitors to cease to

act. That, in turn, would have required an adjournment of trial. QBE had reason to suppose that Pegasus would not be able to continue with its claim if the trial was adjourned; it was aware of Pegasus' very difficult financial situation.

[263] Pegasus argues that the duty of good faith is either a contractual or equitable duty. If it succeeds with its argument that the duty is equitable, exemplary damages may be available. (Exemplary damages are not available for a breach of contract: *Paper Reclaim Ltd v Aotearoa International Ltd* [2005] 3 NZLR 188 at [180]-[183].) It will, it claims, also have the benefit of a less stringent test for causation and remoteness than it must meet for a contractual cause of action. Pegasus acknowledges that it has not claimed exemplary damages in its statement of claim, but relies on *Drane v Evangelou* [1978] 2 All ER 437 (CA) at 440 for the proposition that in the absence of an express requirement for a pleading of exemplary damages in the rules of procedure, exemplary damages do not need to be pleaded.

[264] QBE responds that the obligation on the insurer to act toward the insured with utmost good faith is a contractual duty and requires nothing more than that the parties act honestly (although accepting that in this context, dishonest conduct includes conduct that is capricious or unreasonable). QBE argues that the insurer should not be treated as in breach of the duty of good faith unless fraudulent in its treatment of the claim for the contract as a whole.

[265] QBE says that it has not breached its obligation of good faith to Pegasus but has acted reasonably and fairly in investigating Pegasus' claim and applying the terms of the policy. It says that there was no pre-determination, and emphasises that at the date by which Pegasus says QBE should have paid the claim, Pegasus had not even properly quantified its claim. In relation to business interruption, QBE notes that a claim has never been formally made although accepts that it told Pegasus that a business interruption claim could not be processed until a claim was accepted for material damages.

[266] Finally, QBE says that when the insured decides to reject a claim for whatever reason, a dispute arises and litigation may well follow. In such

circumstances, where the battle lines are drawn, the rules of procedure which govern litigation define the parties rights and obligations concerning disclosure of evidence, there is little room for a meaningful duty of good faith (*Manifest Shipping & Co Ltd v Uni-Polaris Insurance Co. Ltd* [2003] 1 AC 469).

Factual Analysis

[267] I propose to address this aspect of Pegasus' claim by first determining whether there is any substance to the factual allegations and then addressing the legal issues raised by the claim if necessary.

(a) Did QBE delay in dealing with Pegasus' claim?

[268] I have already found that QBE did delay in dealing with Pegasus' claim.

(b) Did QBE pre-determine Pegasus' claim?

[269] Pegasus claims that QBE pre-determined its claim following the telephone call between Mr Chapman and Mr Cameron. That, it says, is apparent from the steps it took following that call. Pegasus cites QBE's failure thereafter to properly investigate the information which Pegasus had provided to it, and its delegation of its obligation to investigate to the liquidators of NZE, who it knew were not impartial.

[270] Aspects of QBE's handling of Pegasus' claim were deficient. It took no attempts to verify the accuracy of Pegasus' system, which could well have provided the comfort it required in relation to stock counts. Nor did it investigate the Monarch stock counts. It requested a report from the liquidator when it had reason to suspect (from correspondence with the liquidators, and from Mr Cameron's remarks) that the liquidators doubted the validity of Pegasus' claims.

[271] With the benefit of hindsight QBE made a very poor choice in deciding to prefer the information from the liquidators, rather than that from Pegasus. But while QBE's handling of the claim and its decision making were flawed, I am not

persuaded this was the result of pre-determination. The liquidators had indicated a view that the stock loss was overstated, but Pegasus knew of this, and could and did provide information to the liquidators during their investigation. Given the liquidators' apparent easy access to critical information, and a presumed access to appropriate skills (the liquidators were from a reputable chartered accountancy firm), there was logic in QBE seeking the liquidators' assistance.

(c) Withdrawal of provisional payment offer

[272] It is clear that the provisional payment offer was withdrawn because of the information that Mr Chapman received from the broker for NZE. It is equally clear that the information that he received from that broker was incorrect. He was told that Thomas Pasley had investigated the allegation of stock loss for AHA, the insurers of NZE. He was also told that the majority of stock had been located in one or other of NZE's warehouses. If QBE had properly investigated these factual assertions, it would have found that Thomas Pasley did not complete its investigation of the Icon stock count. That much was accepted by Ms Paki, the loss adjuster from Thomas Pasley who was called to give evidence for AHA. It could also have established that the missing stock had not been located in other warehouses.

[273] I have no doubt that the insurer should have told Pegasus of this information. Although Mr Chapman undertook to Mr Cameron he would keep the source of the information confidential, he could have done this whilst providing Pegasus with an opportunity to respond to the two factual issues raised. Pegasus appears never to have had that opportunity.

[274] I am satisfied that this aspect of QBE's conduct was unreasonable, as this was information QBE undoubtedly took into account in its assessment of Pegasus' claim, but to which it did not afford Pegasus the opportunity to respond. The information was deliberately withheld from Pegasus. But I think it most likely that QBE withheld the information because of a misguided sense of obligation, rather than to advance its commercial interests.

(d) Other instances of bad faith

[275] In an email dated 18 May 2006, Mr Vincent made the following statements:

> As you assure me you're not going to copy this in to the client, I need to tell you that, as you know, we only got the client's report about 10 working days ago and, in all honesty, it was vague and inconclusive although the client doesn't think that.

And then further on in the email:

> As an aside, if you were running a business and thought you had lost $500k - $600k in stock would you trust someone else to report, and follow it through, to the Police?!!

[276] Mr Vincent's evidence was that he asked that the information not be passed on because he thought Mr Harrison was agitated about the progress of the claim, and that giving him all the detail critical of his investigator's report would only make him more anxious. But Pegasus argues that by raising the question which he did in his email, Mr Vincent was clearly seeking to suggest that Pegasus' broker should also be wary of Pegasus' claim.

[277] Mr Vincent's implicit request that the broker not pass on his thoughts about the claim showed a poor understanding on his part of the relationship between broker and client. However, the content of the communications was in reality inconsequential, and I accept Mr Vincent's explanation as to the reason for his request.

(e) Steps taken during proceedings by QBE

[278] The application for security for costs and the late application to amend to include an allegation of fraud were most likely decisions taken for tactical reasons. That much is apparent from the timing of the applications. In both cases, if granted, QBE would have known that they were likely to substantially hinder Pegasus' ability to proceed with the claim, if not prevent it altogether.

Legal content of duty and application to this case

[279] It remains unclear whether in New Zealand the duty of good faith owed by an insurer is a contractual or equitable duty, and what the precise content of the duty is. But this is not the proper case to resolve that controversy. Even were the jurisdiction to award exemplary damages available to me, I would not do so. The conduct of QBE prior to the commencement of proceedings can generally be described as involving a slow response and ultimately a poor quality decision making process. But to say that is really to say nothing more than that QBE was in breach of contract. Pegasus has its remedy for that. The failure to tell Pegasus of the fact and nature of the communication from a third party (Mr Cameron) was unreasonable; it was a deliberate concealment. In the latter respect, at least, QBE breached its duty of good faith. But a mere breach is not enough. In *Bottrill v A* [2003] 2 NZLR 721 (PC) Lord Nicholls described the purpose of exemplary damages at [20]:

> Exceptionally, a defendant's conduct in committing a civil wrong is so outrageous that an order for payment of compensation is not an adequate response. Something more is needed from the Court, to demonstrate that such conduct is altogether unacceptable to society. Then the wrongdoer may be ordered to make a further payment, by way of condemnation and punishment.

He said, at [23], that cases satisfying the test of outrageousness will:

> … usually involve intentional wrongdoing.

In this case QBE did make attempts to resolve Pegasus' claim to indemnity on the basis of a consideration of the merits, however flawed the process it embarked upon. Moreover, the claim was not an easy one to consider; it was by no means open and shut. And while it should have passed on the substance of the communication received from Mr Cameron, the deliberate concealment of it was not to advance QBE's commercial interests, but because of a misguided sense of obligation. This is not conduct calling for an additional award of damages by way of condemnation or punishment.

[280] There may be more substance in Pegasus' complaints as to the manner in which the litigation was conducted. But I accept QBE's argument that such issues

are to be addressed through the costs regime under the High Court Rules. As QBE argued, once proceedings are on foot between the parties, a litigant must be free to argue its case in accordance with the relevant law and rules of practice. The implications for QBE of its conduct, if any, fall to be determined within the context of the High Court Rules. It would be unfair to fetter either party to litigation with implied equitable or contractual obligations to each other once proceedings have been issued. As Tuckey J said in *Manifest Shipping* when addressing an insured's breach of the duty of disclosure after commencement of proceedings:

> Litigation between insured and insurers has become complicated, prolonged and quite adversarial enough as it is, without the Court having to investigate allegations of the kind which are made in this case, particularly as they are often likely to involve, as they do here, the insured's advisers as well.

[281] As noted above, Pegasus also relies upon what it submits is a fiduciary duty of good faith because, it argues, the less stringent 'but for' test for causation and remoteness then applies. With a less stringent test Pegasus hopes to recover damages for those losses I have held are too remote or for which there is inadequate proof of causation. Pegasus cites *Stevens v Premium Real Estate* [2009] NZSC 15 for the proposition that different rules regarding causation and remoteness apply in an action for breach of the duty of good faith.

[282] I accept that different rules apply to breaches of fiduciary obligations. But *Stevens* was a case that concerned the unambiguously fiduciary duties between real estate agent and vendor. Insurance law is a distinct area that has evolved according to the needs of the unique climate in which it operates, and the principle of good faith in that context has yet to be precisely defined in New Zealand. I can, however, conclude that the duty is not a fiduciary one because it is clear that an insurer must be entitled to protect its own interests (see *CGU Workers Compensation (NSW) Ltd v Garcia* [2007] NSWCA 193 at [60] and *Fidler v Sun Life Assurance Co. of Canada* 2004 CarswellBC 1086, 2004 BCCA 273 at [70] (overturned on a different issue: see [2006] 2 SCR 3**;** 2006 SCC 30).

[283] QBE does not, therefore, owe Pegasus an overarching fiduciary duty of good faith. However, there might be an argument that a similar approach to causation and remoteness is appropriate where the breach is of a duty to disclose. While not an

argument developed before me, QBE's failure to inform Pegasus of the allegations made by Mr Cameron could be characterised as a breach of the duty to disclose. But were I to so characterise it, I would also find that QBE has discharged any evidential onus on it to show that the loss has not been caused by the non-disclosure. Any loss suffered by Pegasus that is recoverable has been caused by QBE's breach of contract, and not by the failure to disclose the content of Mr Chapman's conversation with Mr Cameron.

[284] Pegasus also appears to argue, in reliance upon Thomas J's separate judgment in *Cedenco Foods Limited v State Insurance Limited* HC AK CP203/93, that it is owed an equitable duty of good faith. However, were I to conclude that the duty of good faith in an insurance context is an equitable duty the same principles as to causation and remoteness would apply as to common law claims. It is only in that limited class of case, typically concerned with breach of a fiduciary duty that the 'but for' test for causation is applicable (*Bank of New Zealand v New Zealand Guardian Trust Co Ltd* [1999] 1 NZLR 664). As such, Pegasus would be in no better position than it is in relying upon its contractual cause of action.

E. CLAIM AGAINST AHA

[285] Pegasus brings a claim against AHA to enforce the statutory charge in favour of Pegasus created by s 9(1) of the Law Reform Act 1936. Section 9 of the Law Reform Act 1936 provides:

> **Amount of liability to be charge on insurance money payable against that liability**
>
> (1) If any person (hereinafter in this Part of this Act referred to as the insured) has, whether before or after the passing of this Act, entered into a contract of insurance by which he is indemnified against liability to pay any damages or compensation, the amount of his liability shall, on the happening of the event giving rise to the claim for damages or compensation, and notwithstanding that the amount of such liability may not then have been determined, be a charge on all insurance money that is or may become payable in respect of that liability.
>
> (2) If, on the happening of the event giving rise to any claim for damages or compensation as aforesaid, the insured has died insolvent or is bankrupt or, in the case of a corporation, is being

wound up, or if any subsequent bankruptcy or winding up of the insured is deemed to have commenced not later than the happening of that event, the provisions of the last preceding subsection shall apply notwithstanding the insolvency, bankruptcy, or winding up of the insured.

(3) Every charge created by this section shall have priority over all other charges affecting the said insurance money, and where the same insurance money is subject to 2 or more charges by virtue of this Part of this Act those charges shall have priority between themselves in the order of the dates of the events out of which the liability arose, or, if such charges arise out of events happening on the same date, they shall rank equally between themselves.

(4) Every such charge as aforesaid shall be enforceable by way of an action against the insurer in the same way and in the same Court as if the action were an action to recover damages or compensation from the insured; and in respect of any such action and of the judgment given therein the parties shall, to the extent of the charge, have the same rights and liabilities, and the Court shall have the same powers, as if the action were against the insured:

Provided that, except where the provisions of subsection (2) of this section apply, no such action shall be commenced in any Court except with the leave of that Court.

(5) Such an action may be brought although judgment has been already recovered against the insured for damages or compensation in respect of the same matter.

(6) Any payment made by an insurer under the contract of insurance without actual notice of the existence of any such charge shall to the extent of that payment be a valid discharge to the insurer, notwithstanding anything in this Part of this Act contained.

(7) No insurer shall be liable under this Part of this Act for any sum beyond the limits fixed by the contract of insurance between himself and the insured.

[286] Pegasus says that NZE breached the agreement with it because NZE employees stole stock, did not perform the services owed to the plaintiff expeditiously and with reasonable care, skill and diligence and did not take reasonable steps to ensure that the warehouse or warehouses used in the performance of the services were secured from unauthorised access. It says that NZE is liable to the plaintiff for the loss or damage resulting from that breach.

[287] In its statement of claim and in opening, Pegasus maintained that as a result of the theft by NZE's employees, it has suffered loss of $2,240,629 which is sought from AIG together with interest and costs. That included all costs of calculation of

the indemnity claim, together with consequential losses, the latter including a claim for loss of profits and compound interest. Toward the conclusion of the trial, counsel for Pegasus confirmed that it was accepted both that AHA's liability could be for no more than the limit fixed by the contract of insurance (which is $500,000 less the $25,000 policy deductible) and that Pegasus only seeks to recover the following amounts from AHA:

1. The actual cost of the missing stock: $354,369.

2. Interest on whatever judgment is obtained on this amount under the Judicature Act 1908 from December 2006, which is the date that Pegasus says the claim should have been paid by AHA.

3. Solicitors costs on a 2C scale basis.

[288] Section 9 is a procedural provision which puts the insurer into the same position as the insured for the purposes of Pegasus' claim, with the parties having the same rights and liabilities, and the proceedings against the insurer the same character as any proceedings that would have been instituted against the insured (s 9(4)). But it is common ground that under s 9 of the Law Reform Act 1936, Pegasus can only recover money that was payable by AHA to NZE under its crime management policy (*UEB Packaging v QBE Insurance (International) Ltd* [1998] 2 NZLR 64, per Tipping J).

[289] What remains to be determined between Pegasus and AHA is:

a) whether the exclusion in clause 4.9 (the inventory exclusion clause) applies; and

b) whether AHA is liable for any costs, disbursements and interest on a successful claim by Pegasus against AHA, and if so, the amount of that liability.

The inventory exclusion clause

[290] Clause 4.9, the inventory exclusion clause referred to earlier, provides that AHA is not liable for:

> **Loss**, the proof of which is dependent solely upon a:
>
> (a) profit and loss computation or comparison; or
>
> (b) comparison of inventory records with an actual physical count

This is subject to the following proviso:

> However, where an **Employee** is involved in suspected of causing [sic] **Loss** and has been identified, inventory records and actual physical count of inventory can be submitted as partial evidence in support of proof of **Loss**.

[291] AHA argues that this clause is successfully invoked where both proof of the existence of the loss and its amount are dependent on an inventory computation. It says that proof of Pegasus' claim against AHA, other than for the theft which Securitek captured on the surveillance tapes, is solely dependent on a comparison of inventory records to an actual physical count. And that this is an example of just the circumstances in which the exclusion was intended to apply.

[292] Pegasus does not rely solely upon the comparison of inventory records with physical count to prove either the factual existence of loss or its amount; rather it relies on that evidence to bolster its claim that theft occurred and to quantify the level of theft. There is ample other evidence already discussed that establishes that widespread theft of Pegasus' stock was occurring. It follows that the proviso to the inventory computation exclusion clause applies. The inventory records are relied on as partial evidence only. Indemnity is therefore available.

Liability for costs, disbursement and interest

[293] AHA relies upon exclusion 4.2 which provides that it is not liable to make any payment for "costs, fees or other expenses incurred in establishing the existence or amount of **Loss** covered under this policy, or in prosecuting or defending any legal proceeding". AHA maintains that the solicitors' costs, court costs, and

Mr Cregten's costs sought by Pegasus fall within the exclusion clause. It says the exclusion is not limited solely to the costs and expenses of the insured, and that by including the reference to prosecuting a legal proceeding, specifically envisages that all costs incurred in that process are within the wording of the exclusion.

[294] The exclusion clause to which AHA refers has no application. AHA is liable to pay costs and expenses not by reason of the contract of indemnity, but rather under the regulatory regime created by the High Court Rules. It is liable as a party who has unsuccessfully defended litigation.

[295] AHA also argues that any costs and interest awarded is capped by the policy limit of $500,000, but the policy limit does not apply to the award of interest and costs. The entitlement to interest arises under the provisions of the Judicature Act and exists because of AHA's wrongful failure to pay an amount it was obliged to pay by reason of the provisions of s 9 of the Law Reform Act. It does not depend upon the existence of a contractual entitlement. For those reasons I am satisfied that the policy limitation does not apply. Pegasus is entitled to interest under the Judicature Act from the date that Pegasus issued proceedings against AHA, which was December 2006.

F. AVAILABILITY OF SET-OFF

AHA

[296] AHA submits that Pegasus withheld warehousing fees to recover amounts owing to Pegasus by NZE for invoices in respect of missing stock, and that that amount should be deducted from the amount it is obliged to pay Pegasus. Pegasus argues that AHA should not be allowed to raise the set-off to reduce its liability, since it did not plead it. It says that if it had been pleaded further evidence would have been led to prove that Pegasus had other claims against NZE.

[297] Pegasus is correct that, rather surprisingly, AHA did not plead the set-off (although it did raise the issue of set-off during its opening). But I do not consider

that the failure to plead has prejudiced Pegasus in any way. NZE is in liquidation. Set-off in bankruptcy differs from the general law of set-off and is regulated by s 310(1) of the Companies Act 1993 which provides:

> (1) Where there have been mutual credits, mutual debts, or other mutual dealings between a company and a person who seeks or, but for the operation of this section, would seek to have a claim admitted in the liquidation of the company, -
>
> (a) An account must be taken of what is due from the one party to the other in respect of those credits, debts, or dealings; and
>
> (b) An amount due from one party must be set off against an amount due from the other party; and
>
> (c) Only the balance of the account may be claimed in the liquidation, or is payable to the company, as the case may be.

Insolvency set-off occurs automatically. Liquidation of the debtor company (NZE) operates to extinguish the principal debt as at the date of liquidation, leaving the balance as the amount provable in the liquidation (*Stein v Blake* [1995] 2 All ER 961; *New Zealand Bloodstock Leasing Ltd v Jenkins* HC AK CIV 2004-404-5795, 19 April 2007). This is to be contrasted with legal set-off, which must be pleaded and is effective only with the judgment of the Court.

[298] For this reason, it is difficult to see how Pegasus can have been prejudiced by AHA's failure to plead set-off. The liquidation of NZE had the effect of automatically netting off NZE's and Pegasus' cross claims, leaving an amount owing to Pegasus. AHA is entitled to raise defences available to NZE, including set-off. Pegasus is able to prove in the liquidation of NZE for the balance of its claims. I add that NZE's liquidator would not be able to raise the set-off defence again when dealing with any proof Pegasus may file in the liquidation or sue Pegasus for the warehouse fees, as s 9 is a form of statutory subrogation.

QBE

[299] QBE says that any indemnity Pegasus is entitled to must be reduced by the withheld warehouse fees together with any amounts recovered from AHA as NZE's insurer because both reduce Pegasus' loss.

[300] Pegasus responds that the amount that Pegasus can recover must be assessed without any deduction in respect of the warehouse fees it has withheld. It says that the question for the Court is whether the retention of money is a benefit that Pegasus has received diminishing its loss. It argues that it cannot be where Pegasus could still have to pay the fees to the liquidators.

[301] Clause 29.2.3 is relevant in determining this issue. It provides:

> **29.2.3 OTHER INSURANCE – APPLICABLE TO SECTIONS A, B, C, D & E OF THIS POLICY**
>
> If at the time of any loss, destruction or damage happening to any property hereby insured, there by [sic] any other subsisting insurance or any indemnity provided by any Act of Parliament whether effected by the Insured or by any other person, covering the same property or the Insured's interest therein, the insurance under this Policy shall not apply until the full amount of indemnity under such other property or any indemnity provided by any Act of Parliament has been applied as far as it shall go in satisfaction of the Insured's loss, destruction or damage.

[302] That clause limits QBE's obligation to indemnify to the balance remaining after payment in full under the indemnity provided by s 9 Law Reform Act 1936. (*State Fire Insurance General Manager v Liverpool and London and Globe Insurance Co* [1952] NZLR 5).

[303] As to Pegasus' arguments in relation to the warehouse fees, as I have held, s 9 operates as a form of statutory subrogation. The liquidators will not be able to pursue Pegasus in respect of the warehouse fees, as NZE's rights to claim set-off have already been exercised.

[304] Therefore Pegasus' loss, for which it is entitled to indemnity, is reduced by the amount of the warehouse fees that it withheld and by the amount of indemnity it

is entitled to from AHA. These amounts are to be deducted from QBE's obligation to indemnify Pegasus.

G. RESULT

[305] Pegasus is entitled to judgment against QBE in respect of the breach of contract cause of action for the following amounts:

i) $354,369 for material damage less $2,500 (applicable excess), any amount recovered by Pegasus from AHA pursuant to this judgment (excluding any award for interest and costs), and $197,637.68 to reflect set-off;

ii) $412,588 for loss of gross profit due to business interruption;

iii) Expenses totalling $48,747 ($7,962 for Monarch fees; $25,707 for Bell Gully fees, $9,578 for private investigators; and $5,500 for salaries); and

iv) Compound interest to be calculated in accordance with para [258] of this judgment.

[306] Pegasus is entitled to judgment against AHA for the following amounts:

i) $354,369 for material damage less the $25,000 policy deductible and $197,637.68 to reflect set-off; and

ii) Interest on the judgment sum from December 2006 in accordance with the provisions of the Judicature Act.

[307] In the course of this judgment all amounts I have referred to are exclusive of GST. It may be that some of the damages awards should be for the GST inclusive amount. I have not to date received any assistance from the parties on this, and so have not determined this issue. If the parties are able to agree the position whether

an award should be made for GST, then they may detail that in a consent memoranda. If not, I will receive memoranda and determine that issue.

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Winkelmann J