Insurance Contracts Act – Recent Developments and Proposals for Change

A paper presented to the Australian Insurance Law Association National Conference (Sydney November 2006)

Introduction

> *"The law of insurance varies significantly in different legal systems of the world and even as between different jurisdictions of the common law. In Australia, the law of insurance was formerly unclear and in some respects unjust. Enacting a major reforming statute to be applicable to insurance contracts having an appropriate Australian connection was an important legislative achievement".*[1]

Significant achievement indeed. Dire predictions of interference with competition and market efficiency and unacceptable impacts on the cost of insurance[2] have not, for the most part, come to pass. Rather, there has emerged a regime which is fairer, more predictable and no less efficient than prevailed in the days before the *Insurance Contracts Act 1984*. (the Act). This is not to say, of course, that all has been rosy in the garden. There are those who would say that some corners of the garden have become overgrown with a tangle of unintended consequences which compromise or detract from this legislative achievement.

In September 2003, the Commonwealth Government appointed Mr Allan Cameron AM and Ms Nancy Milne as a Review Panel to undertake a comprehensive review of the Act having regard to these terms of reference:

> *"1. Whether the rights and obligations of insurers and insureds (including persons seeking insurance) under the Act continue to be appropriate, including in light of:*

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1 Kirby P (As he then was) *Akai Pty Ltd v The Peoples Insurance Co Ltd NSW* Court of Appeal unreported 28 April 1995.

2 Australian Law Reform Commission Report number 20 *Insurance Contracts (1982)* para 20.

- *product, regulatory and other developments in the financial services industry (particularly the insurance sector) since the Act was enacted; and*
- *judicial interpretation of the Act.*

2. *Whether any amendments to the Act are required to take account of the matters set out in item 1, and whether there are any deficiencies in the Act, such as aspects of the relationship between insurers and insureds that are not adequately covered;*

3. *Whether any amendments are warranted in order to remove ambiguity and more clearly express the intent of the Act; and*

4. *Any other matters relating to the Act which the reviewers consider it appropriate to examine."*

Because of a concern that s.54 of the Act might be adversely impacting on the cost and availability of professional indemnity and similar types of insurance, a preliminary report on urgent issues relating to that section was sought by 31 October 2003. The panel was equal to what, on any view, was a very demanding schedule for a very demanding task and was able to produce its report on the operation of s.54 (the Section 54 Report) by October 2003. A further report (the Other Provisions Report), dealing with provisions of the Act other than s.54, was brought down in June 2004. Those reports form the basic reference points for this paper which seeks to bring to attention and discuss some of their key recommendations, the issues which underlie them and developments related to them.

Section 54

Sub-section (1) of Section 54 provides:

> *"54(1) Subject to this section, where the effect of a contract of insurance would, but for this section, be that the insurer may refuse to pay a claim, either in whole or in part, by reason of some act of the insured or of some other person, being an act that occurred after the contract was entered into but not being an act in respect of which subsection (2) applies, the insurer may not refuse to pay the claim by reason only of that act but the insurer's liability in respect of the claim is reduced by the amount that fairly represents the extent to which the insurer's interests were prejudiced as a result of that act."*

Many thought twenty years ago that this section would mean the end of the then known insurance world. After all, regulating the circumstances in which a contracting

party could rely upon the terms of the contract was a radical intrusion indeed. Chief Justice Gleeson has said that the section is not "… some kind of gratuitous statutory interference with freedom of contract"[3]. But, those years ago, many worried about precisely that. Testament, though, to the wisdom and fairness of the reform and the ability of an efficient insurance industry to rise to it, is the rather remarkable fact that of all the submissions which the Review Panel received regarding s.54, not one of them sought its removal from the Act[4]. The Panel discovered that, generally, stakeholders were pleased with s.54 and agreed that the rights and obligations it conferred upon parties to insurance contracts increased contractual fairness.

There was a broad concession that the operation of s.54 upon "occurrence" policies should not be amended[5]. However, a central issue attracting the Panel's attention (and, of course, the subject of a significant number of submissions) was the effect of s.54 upon "claims made" policies. Most stakeholders suggested that s.54 was not drafted with claims made policies in mind[6] and there was a view that judicial application of the section to claims made policies has defeated or at least compromised key features of claims made cover in their management of long tail risk. The Panel's report refers to an exchange between Senior Counsel and Hayne J in *Greentree & Anor v FAI General Insurance Co Ltd*[7] in which His Honour referred to the "startling result" that, by the application of s.54, claims made policies had become events based.

The key judicial milestones, of course, were *East End Real Estate*[8] and *Australian Hospital Care*[9]. In the former, it will be remembered, the New South Wales Court of Appeal held that s.54 operated to prevent a claim under a claims made and notified policy from failing merely by reason that the claim, though occurring during the period of insurance, was not notified until after the period of insurance had expired. *Australian Hospital Care* went further. There, the High Court upheld a majority decision of the Queensland Court of Appeal which extended s.54 to provide relief in a

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3 *FAI v Australian Hospital Care* (2001) 180 ALR 374, 397.
4 s.54 Report page 9.
5 s.54 Report page 7.
6 s.54 Report page 7.
7 s.51 Report page 10 – 11.
8 *East End Real Estate Pty Ltd v CE Heath Casualty and General Insurance Limited* (1992) 25 NSW LR 400
9 Supra.

case of failure to notify circumstances. That is to say, the policy was a claims made and notified policy with a deeming provision with respect to circumstances notified during the policy period from which a claim might arise after expiry of the period. Circumstances occurred during the term of the policy but were not notified and the deeming provision was not availed of. A claim arose after the expiry of the policy. The effect of the court's decision was that, if the insurer was to be entitled to refuse a claim, that would be so only because the insured had failed to give notice of the occurrence of circumstances and that was an omission relieved by s.54.

The industry's reaction to the problems thrown up by these cases was to remove deeming provisions and leave an insured to rely upon s.40(3) of the Act which provides as follows:

> *"Where the insured gave notice in writing to the insurer of facts that might give rise to a claim against the insured as soon as was reasonably practicable after the insured became aware of those facts but before the insurance cover provided by the contract expired, the insurer is not relieved of liability under the contract in respect of the claim, when made, by reason only that it was made after the expiration of the period of the insurance cover provided by the contract."*

This technique was proven successful in *Gosford Council v GIO General Limited*[10] and *McInally Nominees Pty Ltd v HTW Valuers (Brisbane) Pty Ltd*[11].

The Review Panel identified these as the possible options for reform of s.54:

> "• *That section 54 be retained in its current form;*
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> • *That section 54 be amended, so that notification by an insured to the insurer, of facts or circumstances which might give rise to a claim outside the period of cover, would be excluded from the relief provided under section 54. Section 54 would still provide relief to an insured in respect of a claim made against the insured during the period of cover, but notified to the insurer outside that period;*
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> • *That section 54 be amended so that notification by an insured to the insurer, of facts or circumstances which might give rise to a claim outside the period of cover, would be excluded from the relief provided under section 54. Section 54 would no longer provide relief to an*

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10 [2003] NSW CA 34.

11 (2001) 11 ANZ Insurance Case at 61 – 507.

insured in respect of a claim made against the insured during the period of cover, but notified to the insurer outside that period; or

- *That section 54 be divided into two sections. The first section would reflect the operation of section 54 in its current form, however, the operation off this section would be limited to "occurrence" policies. A variation of section 54 would be drafted to operate in relation to "claims made" and "claims made and notified" policies. Regulations could prescribe the application of each section to insurance types that may not fall within the specified categories."*[12]

In the result, the Panel favoured the second option which is, in effect, to continue the application of s.54 to save an "*East End*" situation but not an "*Australian Hospital Care*" situation.

An exposure draft amending bill contains these key proposed amendments:

(a) a new s.54A would be inserted. It would provide that s.54(1) will not apply to relieve a failure to notify during the period of insurance of facts that might give rise to a claim under a claims made or claims made and notified policy.

(b) s.40 would be amended by:

(i) requiring insurers to clearly inform insureds in writing not more than 30 days before expiry and not later than seven days before expiry of the effect of subsection (3) unless the contract was arranged by a broker and the insurer becomes aware that the broker has given the relevant information;

(ii) repealing subsection (3) and replacing it with the following:

"If:

(a) the insured became aware, before the insurance cover provided by the contract expired, of facts that might give rise to a claim against the insured; and

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12 s.54 report page 5.

> *(b) the insured gave notice in writing to the insurer of those facts as soon as was reasonably practicable after becoming aware of them but no later than 45 days after the insurance cover provided by the contract expired;*
> *the insurer is not relieved of liability under the contract in respect of the claim, when made, by reason only that it was made after the expiration of the period of insurance cover provided by the contract."*

Following submissions in relation to the draft bill, the panel suggested a reduction of the extended reporting period from 45 days to 28 days[13]. The Panel explained that it at first chose 45 days because of its belief that the majority of indemnity policies in Australia were renewed on 31 December and an extended time of 45 days would allow reporting by insureds upon return from holidays. Subsequent advice that no more than 30% of indemnity policies fall due on 31 December has led to a preference for a 28 days extended reporting period.

The Insurance Council of Australia, in its submission[14] expressed reservations about a period of grace and indicated that its original agreement to such a period was based on the premise that s.54 would be no longer available for relief in respect of late notification of both claims and "facts and circumstances". It submitted, though, in any event, a period of grace should be no longer than 21 days. The Law Council of Australia suggested six months[15] and expressed the opinion that the 45 day period "is arbitrary". The National Insurance Brokers Association pointed to the problem of uncertainty in the minds of insureds about what constitutes a "fact" and suggested an extended notification period of up to 12 months in circumstances where an insured could provide a full and satisfactory explanation for delay (example undertaking investigations).

For my part, I would have thought that the concept of a period of grace is somewhat arbitrary in itself and any particular period of time chosen will be inevitably largely arbitrary. A submission from Phillips Fox reminds us that the period of grace should

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13 Panels letter to the Minister for Revenue and Assistant Treasurer and the Parliamentary Secretary to the Treasurer 28 May 2004.

14 16 April 2004.

15 See its submission of 21 April 2004.

really be about limited indulgence and pre-expiry awareness. It reminds us, too, of cost:

> *"The longer the extended reporting period, the greater the likelihood that something extra has occurred during the new policy period to trigger the notification, so that it is not a genuine reflection of awareness prior to expiry. It can give rise to serious policy shopping issues. Further, we have been informed that, if an extended reporting period is longer than 28 days, the market will charge for it, increasing the premium to the disadvantage of insureds."*[16]

There is both pragmatic and purposive argument for no change at all to s.54. The National Insurance Brokers Association put it this way:[17]

> *"As NIBA perceives it, the proposed amendment to Section 54 will simply remove a potential competitive differentiator between insurers, to the detriment to all insured. Any perceived unfairness in terms of IBNR is inconsistent with the use of continuous cover clauses and the operation of the Australian Hospital Care Case has already been negated by market action.*
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> *For the reasons identified above, NIBA does not recognise any need for amendment of the Insurance Contracts Act by the proposed inclusion of a new Section 54A as is contained in the Exposure Draft, and sees such an amendment as reducing competitive freedom in the marketplace".*

The Review Panel's letter of 28 May 2004 to the Minister for Revenue and Assistant Treasurer and the Parliamentary Secretary to the Treasurer draws attention to this NIBA submission. To my mind, it bears careful consideration, though the Panel's concern seems to be that there is not a wide enough knowledge and understanding amongst insureds of the subtleties relating to removal of deeming provisions and reliance on s.40(3).

Kirby J was completely unambiguous in *Australian Hospital Care*. In his opinion, the case illustrated "exactly the kind of situation in which s.54(1) of the Act was intended to operate and should operate".[18] He agreed with Derrington J that the result was not, as the insurer would have it, a serious departure from the "core", "essence" or "substance" of the insurance cover agreed between the parties[19]. Their Honours

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[16] Submission dated 16 April 2004.

[17] NIBA Submission page 3.

[18] *Australian Hospital Care* [87].

[19] at [88].

would thus say that there is no need for change, not so much because market response has effected the change but because s.54 was working as it was intended.

Provisions Other Than Section 54

Good Faith

The Review Panel gave consideration to the good faith provision in s.13 of the Act in the context of reported experience with claims handling. It expressed the view that the section 13 duty has the potential to provide remedies for some of the issues relating to claims handling and expressed agreement with commentators who have noted that there is a significantly wider scope for insureds to use s.13.[20]

The Panel referred to *Moss v Sun Alliance Australia Ltd*[21], though that decision is not without its critics[22]. Another case often referred to in relation to the "underlying potential" of s.13 is *Australian Associated Motor Insurers Ltd v Ellis*[23] of that decision, though, Chesterman J in the Supreme Court of Queensland said:

> *"This decision appears to me, with respect, wrong. A duty, the essence of which is to act honestly, is elevated to an obligation in an insurer to coddle its insured and to allow idiosyncratic judicial solicitude to replace principle[24]".*

There has, however, been a suggestion that the breach of the insurer's contractual duty of good faith could possibly be recognised as a further exception to the common law's general disallowance of exemplary damages for breach of contract[25].

Of particular interest in relation to the strengthening of the position of insureds as a class, if not individually, is the Panel's recommendation that a breach of the duty of good faith should be both a breach of an implied contractual term (as provided by s.13) and a breach of the Act. Underlying this recommendation appears to be a view

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20 Other Provisions Report, page 2. The Panel referred to *Good Faith and Insurance Contracts – Obligations on Insurers* (1999) 19(1) ABR 89 at 91.

21 (1990) 55 SA SR 145.

22 Re *Zurich Australia Insurance Limited* [1999] 2 Qd.R. 203 at 218.

23 (1990) 6 ANZ Insurance cases 60 – 957.

24 Re *Zurich Australian Insurance Ltd Supra*

25 A paper by Justice McMurdo of the Supreme Court of Queensland presented to the Australian Insurance Law Association "Insurance Intensive" 2006; there has been contention, though unsuccessful, for a tortious duty of good faith – see *Lomsargis v National Mutual* [2005] QSC 199; and Grey Reinhardt, in a submission to the Panel raised the scope for traditional common Law remedies, referring to *Kassem v Colonial Mutual* [2001] NSW CA 38 at [4].

that the position of ASIC in relation to commencement of representative proceedings should be strengthened.

ASIC's principal enforcement remedy arises under s.55A of the Act and, according to ASIC's submission, its limitations are considerable[26]. Making a non compliance with the duty of good faith a breach of the Act would, in the Panel's view, remove any doubt that ASIC would have power to commence representative proceedings in relation to the breach[27].

The Panel's recommendation is that such a breach not amount to an offence nor attract any penalty but it has recognised the possible implications of a breach of the duty for purposes of the licensing provisions in s.920A of the *Corporations Act* 2001[28]. That section enshrines ASIC's power to make a banning order. The Review Panel's view is that isolated breaches of the duty should not give rise to any risk of a banning order but the ordinary operation of the licensing regime generally should mean that repeated breaches or very serious breaches of the duty by an insurer might be grounds for ASIC to consider imposing conditions on an insurer's financial services licence or, in extreme cases, to ask an insurer to show cause why its licence should not be revoked[29].

Not surprisingly, the submission from the Insurance Council of Australia opposes this recommendation[30]. Again, I am able to empathise with the ICA position. Firstly, as they point out, the duty of good faith devolves upon insurer and insured but this measure holds its real implications only for insurers. Secondly, I am not sure the blunt instrument of legislative breach has a true home amongst concepts of good faith underpinned as they are by long common law tradition.

Disclosure

The chief sources of an insured's duty of disclosure are sections 21 and 21A of the Act. The latter section applies only to "eligible contracts of insurance". These are declared in the Regulations and are essentially limited to certain personal lines. Section 21A provides for an insurer to ask specific questions of an insured. The Panel

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26 Paragraph 2.2 ASIC submission 24 December 2003.

27 Other Provisions Report para 1.8.

28 Other Provisions Report para 1.9.

29 Id

30 ICA submission June 2004 para 4.1.

proposes that "catch all" questions will no longer be permitted.[31] It also gave consideration to a s.21A kind of approach to the wider class of insurance contracts beyond "eligible contracts" in recognition of a concern, which it regarded as legitimate, that the duty of disclosure puts an unreasonable burden on insureds whereby they are expected to know what the insurer regards as relevant. In the result, though, the Panel has stopped short of that approach and has instead favoured the introduction into s.21 of what it describes as "non exclusive factors that can be taken into account when determining the application of the duty of disclosure test".[32]

Some such factors have been suggested to be:

(a) the nature and extent of the cover provided by the contract of insurance;

(b) the class of persons who would ordinarily be expected to apply for cover of that type; and

(c) the circumstances in which the contract of insurance is entered into including the nature and extent of any questions asked by the insurer.[33]

Standard Cover and Product Disclosure

There is respectable opinion that the standard cover regime in the *Act* should be abandoned altogether. For a start, there is the perennial difficulty arising from casting standard cover provisions to be borne by that slow moving, often static "beast", subordinate legislation. Inevitably, as the Panel noted, standard cover regulations have not kept pace with market developments. Although the Panel has recommended modernising and updating the regulations, it is likely ever to be thus.

A second and, perhaps more substantive concern arises. The *Financial Services Reform Act 2001* (FSRA) amended the *Corporations Act 2001* to introduce a wide ranging regime of licensing conduct and disclosure for financial service providers including insurers. Some have complained that the system is more about process than substance and that it has imposed a high level of bureaucratic burden and cost for as yet unclear benefit. Of course individual cases can always be found where such a

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31 Other Provisions Report para 4.17.

32 Recommendation 4.1

33 Phillips Fox submission 21 April 2004 page 3 and other provisions report para 4.18

complaint can be sustained but, at a more comprehensive, level, there can surely be no doubt about the contribution to probity and the integrity of the financial services system made by this regime.

It leads some to question, though, why two regimes? Thus, the following appears in the ICA submission[34]:

> *"ICA has previously submitted to the Review Panel that the standard cover provisions should not be retained and that, in light of the PDS obligations, there is no need to modernise the regulations[35]. Insurers' PDS obligations require them to properly disclose to insurers the benefits and risks of cover, in a clear, concise and effective manner. In ICA's view, the policy objective of standard cover has been superseded by the passage of the FSRA. In 1984, the IC Act sought to improve the flow of information from insurers to insureds. In 2001, the FSRA sought to achieve the same goal. the latter Act carries different remedies that are appropriate to the new regulatory framework and competitive market of the present. The standard cover and unusual term provisions of the IC Act (not just the regulations) should be repealed, leaving the PDS regime to function as the single disclosure mechanism."*

The Review Panel has pointed to some important differences between the PDS and standard cover regimes[36] and does not favour a revocation of the standard cover regime. However, I find myself not out of sympathy with the ICA view and wonder whether these differences might not simply signal a need or appropriate occasion for refining the PDS regime rather than founding a permanent maintenance of two regimes. ICA makes the very good point that the standard cover regime was conceived in the early 1980s in a much less competitive personal lines market than exists now. It is reasonable to ask whether an over regulated regime might discourage innovation and competition, including at an international level[37].

Third Parties

The general approach of the Review Panel on the subject of third party beneficiaries appears to have been that, as a matter of principle, third party beneficiaries should enjoy, in appropriate cases, an equivalence with the insured but should be in no better position than the insured. Thus, the Panel has recommended that third party beneficiaries should have access to:

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34 June 2004 page 19.

35 ICA submission on Second Stage Issues Paper, Issue 5.7

36 Other Provisions Report 5.43 – 5.47.

37 See ICA submission June 2004 pages 19 and 20

- the same rights and obligations as an insured for the purposes of subrogation;

- the duty of utmost good faith (but not pre-contractually); and

- the same rights as an insured to give notice to an insurer, for example, pursuant to s.40(3) or s.74[38]

But the Panel recommends that s.48(3) of the Act should be clarified so that it is clear that a third party beneficiary is in no better position than the actual insured in so far as concerns of defences raised by an insurer[39].

The Panel has noted interface issues as between s.51 of the Act and other third party recovery provisions in other legislation such as s.6 of the *Law Reform (Miscellaneous Provisions) Act* 1946 (NSW), s.562 and 601 AG of the *Corporations Act 2001* and s.117 of the *Bankruptcy Act* 1966[40] and has recommended revision to ensure consistent interaction and operation with these legislative provisions. The report does not deal with the s.51 issue raised in *Webb v Estate of Darryl Arthur Herbert*[41] I am not sure that this represents by any means a common problem, but the opportunity for clarification arises. It should perhaps be availed of.

Conclusion

Respectfully, I think it can be said that there is no hyperbole in the description of the *Insurance Contracts Act* as an important legislative achievement. It may, indeed be an understatement of the transforming effect of that initiative.

The Review Panel has managed a complex task in an uncomplicated and highly productive way; for it is no mean matter to assess twenty years of, in some respects, wholly new experience, process detailed submissions coming from a variety of competing perspectives and still arrive at recommendations which are both practical

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38 Recommendation 10.1 Other Provisions Report page 88.
39 Recommendation 10.2 Other Provisions Report page 91.
40 Other Provisions Report page 95 para 10.26.
41 [2006] WA SCA 43.

and protective. Reasonable minds can, of course, differ on this proposal or that but I think it can be said that adoption of the Panel's recommendations will, for the most part rid us of some legislative bath water but leave the baby intact.

R. S. Ashton

30 October 2006