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By Patrick Mead, Partner – February 2010

PROFESSIONAL INDEMNITY INSURANCE – CLAIMS MADE AND NOTIFIED POLICIES – SECTIONS 54 AND 40(3) OF THE INSURANCE CONTRACTS ACT 1984 (CTH)

Professional Indemnity insurance plays a critical role in the management of risk for construction professionals.

Introduction

One of the most contentious applications of s54 of the *Insurance Contracts Act* 1984 (Cth) ("the Act") has arisen in relation to late notification under so called 'Claims Made and Notified' professional indemnity policies. These policies provide indemnity for claims on the basis of notification by the insured to the insurer of a claim made against the insured during the policy period, irrespective of when the act giving rise to the claim occurred.

Cover is sometimes extended to include a claim made after expiry of the insurance period if during the period of insurance the insured became aware of facts or circumstances giving rise to the claim and notified the insurer of those facts and circumstances before the policy expired (a deemed "claim").

A provision such as this reflects the operation of s40(3) of the same Act, which extends cover in 'Claims Made and Notified' policies to include a claim made after the policy period 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 …*[1]

Judicial Authorities

The judiciary first turned its attention to the application of s54 in relation to a 'Claims Made and Notified' policy in the decision of *East End Real Estate v CE Heath Casualty & General Insurance Ltd.*[2]

In finding that s54 was effective to prevent the claim from failing merely because the claim against the insured was notified to the insurer after the expiration of the period of insurance cover, the court refused to read narrowly the language of s54 and extended the operation of s54 to acts which form part of the definition of the risk insured.[3]

Cole J, in *Breville Appliances v Ducrou,*[4] considered that as a result of the decision in *East End:*

> *... Australia is now in a unique position throughout the world in that it is the only country in which there cannot be an effective 'Claims Made and Notified' insurance policy ... an insurer cannot, by appropriate words, define the risks to be covered by the policy where that risk depends upon an act or omission of the insured.*[5]

His Honour made these remarks when called on to consider the application of s54 to a 'Claims Made and Notified' policy. Unlike the situation in *East End* however, which concerned the failure to notify a claim, the insured in this case sought to take the benefit of s54 to relieve against its failure to provide notification of a "circumstance" or occurrence during a particular (earlier) policy period, so as to overcome problems with non-disclosure during the period in which the actual claim arose.

Cole J, while disagreeing with the reasoning in *East End,* considered the decision to be binding upon him. His Honour described the result which he felt obliged to reach as "*obviously absurd*", but held that the omission or failure by the insured to give notice of circumstances was not a basis upon which the insurer could deny indemnity under the earlier policy.[6]

On appeal (ub nom*: FAI General Insurance Co Ltd v Perry)*[7] the majority, (Gleeson CJ and Clarke JA, Kirby P dissenting) distinguished between an omission by the insured to perform an act (which would be excused by s54) and an election by the insured not to extend its cover by notifying the insurer, pursuant to condition 3 or s40(3), of facts which might give rise to a claim (which would not be so excused).[8]

In *Drayton v Martin,*[9] Sackville J held that where an insured, under a claims made and reported policy, fails to comply with the contractual obligation to report a claim made within the policy period, there is an "omission" for the purposes of s54. His Honour held that that was so whether the failure was due to a deliberate "election" by the insured not to make the notification or report, or to some other reason, such as mistake or inadvertence.[10]

In the NSW Court of Appeal in *Antico v CE Heath Casualty & General Insurance Ltd,*[11] Kirby P, in considering whether s54 could relieve against the insured's failure to obtain consent to incur legal costs, declined to follow the reasoning of Clarke JA in *Perry.*[12] Although not resiling from his own dissent in *Perry,* Kirby P followed the reasoning of Gleeson CJ, however confined the Chief Justice's

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reasoning to the case where the insured has a choice whether or not to notify the insurer of circumstances which might, in the future, give rise to a claim against him.[13]

On appeal to the High Court in *Antico*[14], it was said in the joint majority judgement:

> *Section 54(l) uses the phrase "by reason of some act of the insured or of some other person". It does not specify the act or omission of the insured as being a failure to discharge an obligation owed by the insured to the insurer. The legislation is expressed in broad terms and, on its face, there is no reason why the omission of the insured may not be a failure to exercise a right, choice or liberty which the insured enjoys under the contract of insurance ... Submissions by the respondent which were contrary to the above construction of s54(1) and which apparently were based upon the reasoning of the New South Wales Court of Appeal in FAI General Insurance Co v Perry ... should be rejected.*[15]

None of the High Court judges in *Antico* directly addressed the question of whether s54(1) provided relief in respect of the failure to notify circumstances which gave rise to the claim, as the issue was not before them.

It was not until the case of *FAI General Insurance Co Ltd v Australian Hospital Care Pty Ltd*[16] that the High Court was called upon to determine whether s54(1) precluded an insurer from refusing to pay a claim on the ground that the insured omitted to give notice of an occurrence (which may have given rise to a claim) within the period of cover.

It was held by the High Court (dismissing the insurer's appeal) that s54 can be engaged by an omission by the insured to give notice of an occurrence even if that omission results from a deliberate choice by the insured. The High Court noted that the reasoning of the majority in *Perry's* case was inconsistent with *Antico* and must therefore be regarded as overruled.

The High Court concluded that the claim which the insured made on the insurer was for indemnity against liability for an occurrence of which the insured first became aware during the period of cover. The effect of the contract, but for s54, would be that the insurer may have refused to pay the claim by reason of an omission of the insured to notify the insurer of the occurrence which might subsequently give rise to a claim by a third party. The High Court accordingly held that s54 was therefore engaged to prevent the insurer from refusing to pay the claim[17].

In consequence of this decision, the words of Cole J in *Breville Appliances v Ducrou*[18], decrying the death of 'Claims Made and Notified' policies in Australia, once again rang loudly.

After the decision of the High Court in *FAI General Insurance Company Ltd v Australian Hospital Care Pty Ltd*[19] some commentators suggested that one way to potentially militate against the very expansive interpretation given to the operation of s54 as it pertains to notification of circumstances, was to omit from 'Claims Made and Notified' policies, provisions which were commonly included in such policies which reflected the effect and operation of s40(3). The reason for this arises from the wording of s54 itself which is predicated upon 'the *effect of a contract of insurance*'.

In subsequent proceedings before Chesterman JA in the Supreme Court of Queensland in *CA and MEC McInally Nominees Pty Ltd v HTW Valuers (Brisbane) Pty Ltd,*[20] HTW sought to overcome its failure to provide notice, written or otherwise, of a claim to an insurer while the policy was in force, by a combination of s40 and s54. HTW argued that not giving the notice required by s40(3) was an omission, the effect of which was that the insurer could refuse to pay the policy indemnity. It argued that s54 had the effect of not entitling the insurer to do so.

In delivering his judgment, his Honour considered the argument to be '*novel*', noting that the counsel's research had not found any case in which an insured had been '*brave enough or necessitous enough*' to use the sections in combination to this effect. His Honour clearly recognised the arguments sought to extend the operation of the decision of the High Court in the *Australian Hospital Care* case. In distinguishing the *Australian Hospital Care* decision his Honour noted:

> *The present case is different, the policy would not have entitled HTW to indemnity had (the underwriter) been given notice of their negligent valuation. Section 40(3) would have obliged [the underwriter] to grant indemnity, but that indemnity would have flowed from the intervention of the statute, not the effect of the policy. In this regard the phrase, 'but for the section', which appears in s54(1) cannot be overlooked.*
>
> *…. To assist HTW here s54 has to be understood as though it read:*
> *… where the effect of a contract of insurance would, but for this section, and s40(3) …* [21]

In concluding that s40(3) did not imply into policies of insurance a term to the same effect as the subsection, his Honour concluded HTW's contention that their policy indemnified them in respect of the valuation by a combination of s40(3) and s54(1) was wrong.

The issue of the relationship between s40 and s54 was again considered by Bergin J in the decision handed down on 13 June 2002 in *Gosford City Council v GIO General Ltd.*[22]

In this case, the plaintiff, Gosford City Council, sought indemnity from the defendant under a policy of insurance which expired on 31 December 1991 and which was not renewed. On 30 May 1991, during the period of the policy, an officer of the plaintiff telephoned the plaintiff's insurance broker advising of circumstances which might give rise to a potential claim against the plaintiff. The

broker did not notify those circumstances to the defendant insurer. The defendant subsequently declined to indemnify the plaintiff with respect to the claim on the basis that the wording in the policy required that a claim be made against the plaintiff during the period of insurance and that no such claim was made against the plaintiff during that period.

In that case the plaintiff submitted that there was a failure (through the broker) to notify facts during the currency of the policy. It was also submitted that by a combination of s40(3) and s54, the failure to notify those facts did not entitle the defendant to refuse to indemnify the plaintiff.

The defendant submitted that the failure to notify those facts did entitle the defendant to refuse to indemnify the plaintiff. The defendant submitted that s40(3) and s54 did not operate so as to bring the claim within the policy. In particular it was submitted that, absent special conditions in the policy, s54 did not apply to instances of a 'Claims Made policy' where no claim had been made upon the insured within the policy period. It was submitted that the notification by the plaintiff to its broker did not advance matters because there was no clause in the policy that deemed a later claim to have been made at an earlier time in which circumstances where notified.

Her Honour noted that the facts in the cases relied upon by the plaintiff were each distinguishable from the facts in the case before her. In *Antico*, a claim was made during the period of insurance and there was a failure to notify the insurer during that period. Similarly, in *East End Real Estate Pty Ltd v CE Heath Casualty & General Insurance*[23] a claim was made during the period of insurance and there was a failure to also give notification.

In *Newcastle City Council v GIO General Ltd*[24] there was a notification during the period but the claim was made outside the period. In both *Australian Hospital Care* and *Einfeld v HIH Casualty and General Insurance Ltd*[25] there were deeming provisions. In the case before Bergin J. there was no deeming provision, there was no claim made during the period, and there was no notification during the period.

Her Honour went on to consider the decision of Chesterman J in *McInally Nominees* and noted that the opinion in that case was contrary to that expressed by Rolfe J in *Einfeld,* which her Honour noted was obiter dicta. Bergin J respectively disagreed with *Einfeld*, being of the view that the decision appeared to overlook the limitation found in s54 itself. It operates only where, but for the section, an insurer could refuse indemnity by reason of an omission to give notice.

Bergin J, also noted the emphasis in the joint judgment of McHugh, Gummow and Hayne JJ in the *Australian Hospital Care* case on the point that s40 and s54 deal with different problems. Section 40 is concerned with certain contracts of liability insurance and, among other things, with the insured giving notice of a potential claim during the period of insurance cover when the claim is not made until after the expiration of the period. By contrast, s54 is concerned with the much more general subject of an insurer refusing to pay claims.

In concluding that, as a matter of law, the defendant was not obliged to indemnify the plaintiff under the policy, Her Honour observed that what the plaintiff was seeking to do was to utilise the combination of s40 and s54 to imply a deemed claims clause and then, utilise the legislation again to claim that, notwithstanding the implication, the plaintiff omitted to comply with the requirement of the implied term. It would follow that but for that omission, the later claim would have been deemed to have been made within the policy period. Her Honour noted that the plaintiff's submissions would require modifications to the subsection and provide relief other than that specified in the legislation. There was nothing within the legislation that would justify the statutory implication of a contractual term or a statutory extension of the policy.

The decision of Bergin J went on appeal to the New South Wales Court of Appeal.[26] Sheller JA delivered the Court's judgment and dismissed the Appeal by the insured.

The Court of Appeal observed that Bergin J had found that the insured did not give written notice of a potential claim before the period of insurance expired and that the claim that was made upon the insured was made after the expiration of the policy.

The Court of Appeal, whose reasons accorded with those of the trial Judge said [at 37]:

> *… the contract of insurance was a claims made policy. No claim was made against the insured within the temporal limits of the period of insurance. The insured's right to indemnity depended upon the third party's demand on it being made within the period of cover. The claim that was made on the insured was made outside that period. That fact was decisive unless s40(3) applied. If the subsection operates it denies the insurer escape from liability because the claim against the insured was not made within the temporal limits. To invoke s40(3) the insured must have given 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. This was not done. In my opinion, that is the end of the matter. The occasion for s40(3) to operate did not happen. Accordingly, the subsection does not apply to prevent the insurer contending that the claim is not within the policy.*

Conclusion

As a result of the decision of the High Court in *FAI v Australian Hospital Care*,[27] an insured can avail itself of s54 to excuse a failure to notify circumstances which could give rise to a claim outside of the policy period. Subsequent cases by lower courts have however sought to confine the effect of that decision to situations where

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the policy of insurance contains a deeming provision on terms similar to that contained in s40(3).

In February 2007 a draft reform package was released by Commonwealth Treasury Department with a view to an overhaul of the *Insurance Contracts Act* 1984 (Cth), including provisions directed to ameliorating the consequences of the *Hospital Care* decision.

The effect of the proposal, if subsequently made law, will be to preclude an insured relying on s54 where it has failed to notify circumstances which could give rise to a claim, either prior to the expiration of the policy of insurance or within a 28 day period of grace provided for.

The draft reform package remains on hold although it is understood that the exposure draft (with possible changes) may be progressed in March of this year.

[1] The insured must receive notice of this right and, if the contract does not provide cover in respect of pre-contract events, notice of this must also be given (s40(2)). For an analysis of s40 and, in particular, its application to claims made policies (in contrast to claims made and notified policies): see *Newcastle City Council v GIO General Insurance Ltd* (1994) 8 ANZ Ins Cas 61-227.
[2] (1991) 25 NSWLR 400.
[3] Ibid at 403-5, 407-8, 410.
[4] (1992) 7 ANZ Ins Cas 61-125.
[5] Ibid at 77,628.
[6] Ibid at 77,629.
[7] (1993) 30 NSWLR 89.
[8] Ibid at 93.
[9] (1996) 9 ANZ Ins Cas 61-322.
[10] Ibid at 76,596.
[11] (1996) 38 NSWLR 681.
[12] Ibid at 707. The remaining members of the Court of Appeal, Priestley and Powell JJA did not address this issue.
[13] Ibid at 706. Kirby P considered that Gleeson CJ's reasoning was explicable in terms of legal policy. The application of s54 to an insured's failure to notify circumstances strikes at the very notion of claims made and notified policies, and the President thought that the balance of the Chief Justice's judgment had to be read in that context.
[14] *Antico v CE Heath Fielding Australia Pty Ltd* (1997) 188 CLR 652; 146 ALR 385; [1997] HCA 35; BC9703412.
[15] Ibid at CLR 669; ALR 396,in the judgment of Dawson, Toohey, Gaudron and Gummow JJ. See also *FAI General Insurance Company Ltd v Australian Hospital Care Pty Ltd* (2001) 204 CLR 641.
[16] (2001) 204 CLR 641.
[17] It was noted in a subsequent decision of the New South Wales Supreme Court in *Gorczynski v W&FT Osmo Pty Ltd (2009)* NSWSC 693 [per Simpson J at para 82], that the majority of the High Court drew a distinction between an insurer's refusal to pay a claim by reason of an omission (in which case s54(1) operated to override the provisions of the policy entitling it to do so) and an insurer's refusal to pay a claim because, on examination, it is not a claim for which the policy provided cover (in which case, s54 has no application).
[18] (1992) 7 ANZ Ins Cas 61-125.
[19] (2001) 204 CLR 641.
[20] (2001) 188 ALR 439. For a discussion of *McNally* see K Sutton "Occurrence notified" clauses in insurance policies' (2002) 17(2) *Australian Insurance Law Bulletin* 9.
[21] Ibid at [43].
[22] (2002) 12 ANZ Ins Cas 61-527.
[23] (1991) 25 NSWLR 400 at 403-404.
[24] (1997) 191 CLR 85.
[25] (1999) 166 ALR 714.
[26] (2003) 56 NSWLR 542.
[27] (2001) 204 CLR 641.

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CN|Construction & Engineering Recent Elevation and Appointment

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Carter Newell is pleased to announce the elevation of John Matthews to Associate in the Construction & Engineering group. John has a particular foucs on front-end drafting, risk analysis and risk management as well as construction dispute resolution, litigation and claims under the BCIPA.

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Carter Newell is also pleased to welcome Elisha Goosem to the firm as an Associate in the Construction & Engineering group. Elisha specialises in the defence of professional liability claims and will draw upon her experience in professional indemnity claims across a number of professions to focus on construction professionals liability, as well as construction liability & contract works insurance.

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