Insurance Newsletter

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Resisting claims brought directly against insurers by claimants

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Introduction

The recent case of *Smart v AAI Ltd; JRK Realty Pty Ltd v AAI Ltd*[1] concerned two proceedings brought by Mr Nathan Smart (**Smart**) and JRK Realty Pty Ltd (**JRK**) pursuant to s 601AG of the *Corporations Act 2001* (Cth), where Smart and JRK sought to obtain damages directly against the insurer of a deregistered entity.

The decision provides a useful reminder of the criteria the courts will use to determine whether an insurer is directly liable to a plaintiff.

Background

Smart and JRK (**plaintiffs**) transferred $176,000 and $91,000 respectively to Q1, a finance broker who represented that those funds would be used to make loans to clients of Q1 for which the plaintiffs would receive interest payments.

The plaintiffs never recovered the funds they transferred, although they received what was believed to be '*interest*' for a period.

Q1 was subsequently wound up and deregistered. It did however have a '*claims made*' insurance policy during the period May 2007 to May 2008.

The proceedings concerned whether s 601AG could be invoked in the circumstances.

Issues

Section 601AG allows a person to claim against the insurers of a deregistered company an amount payable to the company under an insurance contract if:

1. the company had a liability to the person; and
2. the insurance contract covered that liability immediately before deregistration.

There was no substantial dispute as to the liability owed by Q1 to both plaintiffs. Q1 clearly promised to lend the plaintiffs' funds to its clients and direct repayment of the loans to the plaintiffs. This repayment never occurred and as a result Q1 was liable to the plaintiffs for breach of contract. Additionally, there was a finding of false and misleading conduct contrary to the former s 52 of the *Trade Practices Act 1974* (Cth) (now s 18 of the Australian Consumer Law).

The principle question for the court was whether or not the insurance contract covered that type of liability immediately before deregistration. The most contentious issues were whether:

1. a '*claim*' as defined was made against the insured during the period of insurance;
2. the insurer could rely on the assumption of liability exclusion clause; and
3. the insurer could rely on the fraud exclusion, including whether it could avoid the write back clause.

Decision

Was a '*claim*' made during the period of insurance?

Critical to the plaintiffs' case was a requirement that they made an insurance claim during the period of insurance. The period of insurance expired on 31 May 2008.

For the plaintiffs to prove they had made a '*claim*', it was necessary for them to demonstrate that they had made a demand for compensation. The only two documents recording the making of a demand prior to 31 May 2008 were a statutory demand of 5 May 2008 and an email of 27 May 2008. The court found that neither of these documents made any assertion of a breach of a duty or obligation and therefore did not constitute a '*claim*'. The email only sought repayment of certain amounts in accordance with the agreed '*investment*' terms, and the statutory demand simply sought the repayment of an alleged debt.

Arguments were raised that s 601AG(b) does not require a claim be made at all, so long as the policy '*covered*' the liability to the plaintiffs. The court confirmed that if the policy in question is a claims made policy, s 601AG(b) does not require a claim to have been made at or before the time of deregistration provided it is made at a time when, assuming deregistration had not occurred, the policy would be engaged. In other words, so long as a policy is still in force, a claim can be made.

In this case, the policy had clearly expired on 31 May 2008, and as no legitimate claim had been made at that time, the policy was not triggered.

Assumption of liability

The insurer also relied on the assumption of liability clause which excluded liability arising directly or indirectly from or in respect of any liability which is assumed by the insured *outside the normal course of the Professional Services*.

The '*liability assumed*' in this case was the liability assumed by Q1 to the plaintiffs by reason of it accepting their funds, promising to lend them to a client, but failing to do so. The liability that the insurer sought to exclude was the contractual liability and a liability for misrepresentation by reason of that conduct.

Whether the insurer could in fact avoid this liability depended on whether or not the liability identified above was '*outside the normal course of Professional Services*'. The court accepted expert banking evidence to the effect that once Q1 approached the plaintiffs and received funds from them, they ceased to be acting as mortgage brokers. This conduct was alien to the function of mortgage or finance brokers, and was a transaction that involved a far greater level of attendant risk for the insured. Ultimately Q1 had

> The contractual liability to indemnify an insured's liability does not end with the demise of the insured, but the relevant policy still needs to be triggered in accordance with its terms and conditions.

assumed this liability and the insurer was able to rely on the exclusion.

Fraud exclusion

The insurer sought to rely on the fraud exclusion because the liability arose from dishonest and fraudulent acts. There was little debate as to whether the acts did have the requisite dishonest and fraudulent elements. The focus centered on whether the relevant agent, Q1's general manager Damian Lynch, was an employee of Q1 in the context of a write back of cover for fraud if it was '*committed by an employee*'.

The court was required to assess the totality of the relationship between Q1 and Mr Lynch to determine whether he was an employee. The court found that Mr Lynch was best described as a half owner, rather than an employee.

In coming to this conclusion the court was persuaded by the following:

1. Mr Lynch held 50% of Q1's shares;
2. Mr Lynch was not paid a wage, did not get sick leave, annual leave or superannuation;
3. Mr Lynch would tell his co-owner how much money he would need for the month to pay all of his expenses and receive that amount into his account; and
4. Q1 was operated out of Mr Lynch's private residence.

The write back was not engaged and the insurer succeeded in establishing that the policy did not respond to the dishonest acts of Mr Lynch.

Comment

As insurers are aware, their contractual liability to indemnify does not necessarily end with an insured dying, going missing or in the case of companies, being deregistered. Plaintiffs may invoke these provisions to assist their claims to be resolved with insurance money when dealing with absent or financially distressed individuals and entities, and it is therefore useful to be reminded how these claims can be defeated.

This case provides useful guidance on the requirements for a plaintiff to succeed against an insurer under s 601AG, in essence requiring a valid claim to be made during the period for which the company holds the insurance policy.

The reasoning from this case may apply equally to the similar provisions in other legislation, such as s 51 of the *Insurance Contracts Act 1984* (Cth) which allows a person to claim against the insurer in circumstances where the insured holds a contract of insurance that covers the liability and the insured has died or cannot be found.[2]

[1] [2015] NSWSC 392.
[2] See also, *Law Reform (Miscellaneous Provisions) Act 1946* (NSW) s 6; *Workers Compensation Act 1987* (NSW) s 162.

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Upcoming presentation - Sunshine Seminar

Transferring Cyber Risks: Are we as an industry getting it right?

Senior Associate **Katherine Hayes** will examine whether the insurance industry is getting cyber risks right as part of a panel discussion alongside industry colleagues **Emma Osgood**, NSW Commercial Practice Leader, Financial Lines, AIG and **Jaydon Burke-Douglas**, Specialty Risks Practice Leader, DUAL Australia at the Sunshine Seminar 2015. Moderated by **Eric Lowenstein**, Cyber Risks Practice Leader, Financial Services Group, Aon, the panel discussion will take place on Tuesday 21 July, 9.30am to 10.30am.

Providing access to the latest industry information, forecasts and quality networking, the **Sunshine Seminar 2015** is one of the mainstays of the annual insurance calendar. Themed '*Industry Insights*', the seminar will be held at the iconic InterContinental Sanctuary Cove Resort from Sunday 19 - Tuesday 21 July.

Featuring one-and-a-half days of presentations on the industry's biggest issues, this event is a must attend for senior insurance professionals who want access to the latest industry information, forecasts and quality networking.

To find out how to register, please visit www.carternewell.com

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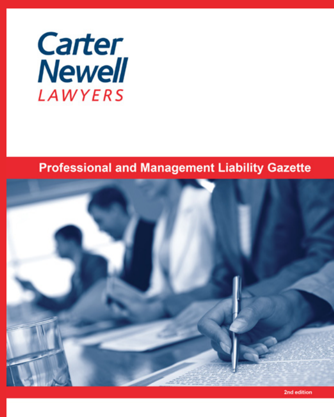
Professional Management and Liability Gazette 2nd edition



The Professional and Management Liability Gazette 2nd edition joins our extensive suite of publications compiled to assist our clients in their daily operations.

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