wotton kearney
insurance lawyers

INSURANCE CONTRACTS ACT REFORM PACKAGE

INTRODUCTION

On 12 February 2007 the Federal Government released a draft reform package that contained a long awaited draft bill to amend the Insurance Contracts Act 1984 (Cth) (**the ICA**). The draft reform package comprises of a draft bill, draft regulations, explanatory materials and a draft regulation impact statement.

The draft reform package arises from a panel (**the Panel**) review of the ICA which the Federal Government instigated in 2003 to ensure that the ICA continues to meet its original consumer protection objectives and does not discourage insurers from writing policies in Australia[1]. The review was undertaken in two stages. First a review and report in relation to section 54 with the Panel's first report released in November 2003. The Panel's second report in March 2004 was in respect of the other sections of the ICA.

The Panel's main conclusion was that the ICA was generally working satisfactorily to the benefit of insurers and insureds. However some amendments were required in order to address developments in the insurance market since 1986 and subsequent judicial interpretation of ICA provisions. The draft reform package adopts the key recommendations of the Panel's reports which were said to be aimed at updating the ICA, responding to market developments, clarifying provisions in light of judicial interpretation and addressing anomalies in the operation of the ICA.

The government requested comments upon the draft reform package by 23 March 2007. While the proposed amendments are only draft amendments, they have arisen from a long consultation process and as such we do not expect there to be any significant amendments in the final bill which is expected before Parliament in late 2007.

Many of the proposed amendments apply to insurance contracts generally while others are specific to life or general insurance including workers compensation insurance. This paper will concentrate on the proposed amendments to general insurance and will refer only in passing to the amendments affecting life insurance and workers compensation insurance.

---

[1] press release CO87/03, 10 September 2003, issued by the then Minister for Revenue and the Assistant Treasurer

SCOPE AND APPLICATION

Extended Jurisdiction

Section 8 provides that:

- the ICA applies to all contracts of insurance whose "proper law" is Australian law; and

- the ICA cannot be avoided by any "choice of law" provision in the contract.

The stated purpose of the amendments to s8 are to ensure that the rights and responsibilities which are conferred on the insureds and insurers under the ICA apply uniformly to all contracts of insurance issued to Australian insureds in respect of an Australian risk. The Panel was keen to ensure that direct offshore foreign insurers (DOFIs) did not have a competitive advantage over local based insurers.

The draft bill inserts a new Section 8(1A) which extends the application of the ICA to all policies which:

- are entered into in Australia; and

- which provide cover against the risk of loss or damage occurring in Australia.

We consider that the proposed amendments to Section 8 are too wide in that they seek to apply to every insurance contract which has any connection to Australia. This could potentially mean that the ICA would apply to an overseas policy in favour of an overseas international company which had only a small proportion of the risk in Australia. The excessive width of the amended provision is shown by the example that it would potentially apply to an overseas travel policy in respect of a loss which occurred in Australia.

Accordingly the effect of the amendments to s8 go beyond remedying the perceived problem with DOFIs which the Panel sought to address and there is a danger that it could result in overseas insurers being reluctant to include any Australian risk in any worldwide cover.

The proposed amendments are also likely to be ignored by foreign courts. In ***Akia Pty Ltd v People's Insurance Company*** [1997] 188 CLR 571 the High Court held that the ICA applied to a Singapore insurance contract entered into by an Australian subsidiary of an international company and a Singapore insurer, even though the stipulated law of the contract was English and there was an English exclusive jurisdiction clause. However ultimately the UK High Court gave effect to the parties' agreement by granting an injunction to the insurer precluding Akia from continuing its case in Australia. Accordingly while the Australian legislature may require that the ICA applies to all insurance contracts that have a connection to Australia, foreign courts are unlikely to be complicitous to that requirement.

Other Provisions affecting scope and application

The proposed amendments to the ICA also provide for:

1 the ICA to apply to those common law parts of workers compensation policies. This confirms the High Court's decision in ***Moltoni Corporation Pty Limited v QBE Insurance Limited*** [2001] 205 CLR 149;

2 the ICA to apply to marine insurance which covers the transportation of property that is wholly or substantially used for personal, domestic or household purposes (s9A); and

3 the unbundling of life insurance contracts (s27A).

UTMOST GOOD FAITH

Section 13 of the ICA implies into every contract of insurance a provision that requires parties to the contract to act towards each other with utmost good faith. The draft bill amends section 13 to:

1 provide that a breach of duty of utmost good faith is a breach of the ICA; and

2 extends the duty of utmost good faith to apply to third party beneficiaries, but only after the contract is entered into.

The perceived problem requiring the proposed amendments to Section 13 is the prevention of poor and inefficient claims handling practices by insurers which are said to have a negative impact upon an insured's business. While the Panel recognised that the Insurance Industry had, by self regulation, addressed some of its concerns relating to the claims handling process in particular the General Insurance Code of Practice, the Panel considered that it would be beneficial for the extended obligation of utmost good faith to be policed by ASIC should that self regulation fail to improve the claims handling processes by a particular insurer.

As a breach of duty of utmost good faith will constitute a breach of the ICA, the Australian Securities and Investments Commission (**ASIC**) will be entitled to commence proceedings against an insurer on behalf of an insured and seek various remedies against that insurer of a kind that can be obtained under the Corporations Act 2001 (Cth). Accordingly ASIC's powers under the ICA will correspond with its powers under the Corporations Act. In addition ASIC is to be given a statutory right to intervene in future proceedings concerning matters arising under the ICA.

Section 14 of the ICA provides the relief for a breach of utmost good faith. The proposed amendments seek to extend that relief so that a party is not entitled to rely on a provision in the insurance contract or the ICA, if reliance on that provision would be a breach of utmost good faith.

This is a significant expansion to the duty of utmost good faith as it means that the application of the ICA (and the insurance contract) will always be subject to the parties' duty of utmost good faith. Accordingly a failure by any party to act with utmost good faith may disentitle that party from relying upon a provision of the ICA.

DISCLOSURE AND MISREPRESENTATIONS

Section 21 requires an insured to disclose every matter that it knows, or reasonably could be expected to know in the circumstances, would be relevant to the insurer's decision whether to accept the risk and enter the contract.

Section 21A (which applies to eligible contracts of insurance defined as motor vehicle, home buildings, home contents, sickness and accident, consumer credit and travel) permits an insurer to seek disclosure of "exceptional circumstances" that the insured, or a reasonable person in the circumstances, would be expected to know are relevant to the insurer's decision whether to accept the risk.

The Panel considered that sections 21 and 21A imposed an unreasonable burden on insureds in that:

- an insured is required to know what an insurer regards as relevant to its decision whether to enter a contract of insurance; and

- the formulation of "a reasonable person in the circumstances" test sets a partly objective and partly subjective test on disclosure. There is conflicting authority as to the extent to which objective factors which are particular to the insured (such as education and cultural background) can be taken into account in applying that test.

The draft bill provides non-exclusive factors to which the Court may have regard in determining the extent of the reasonable person's knowledge. Those factors are:

1 the type of cover to be provided;

2 the class of persons for whom that type of cover is provided in the ordinary course of the insurer's business (for example, is it the type of cover normally provided to sophisticated business clients or to unsophisticated consumers); and

3 the circumstances in which the insurance contract was entered into, including the type and extent of questions asked by the insurer.

The purpose of the amendments is to assist the Court in a uniform determination of the extent of an insured's required disclosure, which would thereby address the current legal inconsistencies between States.

The proposed second factor in the determination of the extent of a reasonable person's knowledge has the potential to lead to a different duty of disclosure being applicable to different insurers because of the nature of the risks that they underwrite. That criteria refers to "*the insurer*" rather than "*an insurer*" and will therefore depend upon that particular insurer's book of business. We consider that the duty of disclosure should be uniform for all insurers and consequently the amendment should refer to "*the ordinary course of an insurers' business*" .

The amendments to Section 21A provide that an insurer (in respect of an eligible contract) must only ask specific questions of the insured and is prevented from

posing "catch all" questions. In addition, Section 21A now applies to all renewals, extensions and variations to an eligible contract, rather than only to contracts for "new business" as before.

The amendments to Section 21A will come into force 12 months after Royal Assent to the draft bill and will be applicable to all contracts of insurance irrespective of when they were entered into.

Notice to an Insured regarding Duty of Disclosure

Section 22 recently requires an insurer to clearly inform prospective insureds of the general nature and effect of the duty of disclosure prior to the entering into of the contract.

As there can be a delay between the receipt of such a notice and the inception of the policy, the Panel perceived that there could be a problem of an insured not appreciating that its duty of disclosure extended until inception of the policy.

The proposed amendments to Section 22 provide that:

1 A notice provided to an insured pursuant to Section 22 should explain that its duty of disclosure applies until the proposed contract of insurance is entered into; and

2 If there is more than a 2 month delay between the insurer's agreement to provide cover and receipt of the proposal, the insurer has to provide the insured with a further reminder of its duty of disclosure at the time the insurer communicates its agreement to provide cover. (In order to have any effect such a notice will have to occur prior to policy inception).

An insurer who fails to comply with its duty to provide notice under Section 22 is precluded from exercising any right in respect of any non disclosure by the insured, unless that particular non disclosure is fraudulent. Accordingly an insurer will have to have complied with its notice obligations under Section 22 in order to be able to exercise any rights in respect of all non-disclosure that is not fraudulent.

The amendments to Section 22 will apply to all contracts of insurance entered into 12 months after the Royal Assent.

NEW RELIEF FOR INNOCENT NON-DISCLOSURE/MISREPRESENTATION

Section 28 provides the available remedies for non-disclosure and misrepresentation. For innocent non-disclosure and misrepresentation, the insurer is only entitled to reduce its liability to the extent that it can establish prejudice. Any fraudulent non-disclosure/ misrepresentation entitles the insurer to avoid the contract.

Due to the potential for an insurer to avoid a contract for any fraudulent non-disclosure/misrepresentation irrespective of its nature or effect, Section 31 allowed the Court to disregard the insurer's avoidance of the contract if it was deemed harsh and unfair not to do so, and any prejudice to the insurer is only minimal or insignificant.

The Panel recommended that the relief under Section 31 should be expanded to all cases of non-disclosure/misrepresentation (both innocent and fraudulent) in circumstances where the liability of the insurer had been significantly reduced.

We consider that the proposed amendment to Section 31 provides an additional hurdle to an insurer seeking relief for any innocent non-disclosure/misrepresentation. If an insurer is able to overcome the difficulty of establishing prejudice sustained by reason of an innocent non-disclosure/misrepresentation we fail to see why it should then have to counter any arguments that its reduced liability arising from that prejudice is harsh or unfair. Under the provision of s28(3) the extent of the insurer's prejudice determines the extent to which it can reduce its liability.

In addition, the wording of the draft Section 31 is inherently contradictory in that the discretion to overrule the reduction in the insurer's liability may only be exercised where:

1 the liability of the insurer has been significantly reduced under Section 28(3);

2 it would be harsh or unfair not to do so; and

3 the insurer has not been prejudiced or that prejudice is minimal or insignificant.

However Section 31 will only apply where the reduction of an insurer's liability has been significantly reduced, which can only occur when it is held to have suffered significant prejudice under Section 28(3). Any "minimal" or "insignificant" prejudice will not lead to a 'significant' reduction in the insurer's liability which would mean that Section 31(1) would not be applicable.

The amendments to Section 31 are intended to apply to all contracts of insurance that are entered into 12 months after Royal Assent.

NON STANDARD PROVISIONS

Sections 35 and 37 currently provide that an insurer should give notice to the insured of:

1 any change from standard cover in a prescribed contract (a contract to which the standard cover provisions apply) (s35); and

2 unusual terms in the case of any other contract (s37).

In both those sections the insurer's present obligation is to "clearly inform" the insured in writing of the nature and effect of the contract or provisions.

Under the proposed amended Sections 35 and 37 the requirement to "clearly inform" has been changed to a requirement to inform in a "clear, concise and effective" manner which mirrors the disclosure standards under the product disclosure statement requirements of the Corporations Act.

Insurers that fail to disclose the existence of a non-standard or unusual term in a clear, concise and effective manner will be treated as not having provided the required disclosure, the effect of which will be to prevent them from later seeking to rely on that term to deny a claim.

The amended Sections 35 and 37 will apply to all contracts of insurance entered into at least 2 years from Royal Assent.

THIRD PARTY BENEFICIARIES

Under the proposed amendments a third party beneficiary is defined under the ICA as *"a person who is not a party to the contract but is specified or referred to in the contract, whether by name or otherwise, as a person to whom the insurance cover provided by the contract extends"*.

The Panel's objective was to ensure that third party beneficiaries have the rights and obligations that are in keeping with the context and intention of their relationship with both the insurer and the insured. The Panel considered that whilst third party beneficiaries require cover under a contract of insurance which is comparable to the named insureds, they have few of the insured's rights and responsibilities.

The following amendments are proposed:

1 an extension of the duty of utmost good faith to third party beneficiaries. However as the identity of third party beneficiaries is likely to be unknown prior to the inception of the policy, the duty of utmost good faith only arises after the contract is entered into (Section 13);

2 amendments to Section 48(2) to make it clear that in defending an action by a third party beneficiary a general insurer may raise defences relating to the conduct of the insured (for example non-disclosure);

3 confer upon third party beneficiaries the same right as an insured in respect of subrogation (Section 64); and

4 extend to third party beneficiaries the same rights as an insured to give notice under the following sections of the ICA:

4.1 S40(3) notifying the insurer that the third party beneficiary has become aware of facts which might give rise to a claim;

4.2 S41 requiring the insurer to elect whether to extend indemnity to a third party beneficiary or waive any contractual prohibition in respect to making any admission or entering into settlement; and

4.3 S74 requiring the insurer to provide a third party beneficiary with a policy wording.

Due to the problem of identifying the third party beneficiaries prior to the inception of the policy, the notice provisions by which the insurer is to provide notice to the insured do not extend to third party beneficiaries.

CLAIMS MADE AND NOTIFIED POLICIES

The Panel sought to amend Section 54 and its interaction with Section 40 (particularly S40(3)) in light of the High Court decision in ***FAI General Insurance Co Limited v Australian Hospital Care*** [2001] 180 ALR 374, subsequent legal authorities (***Gosford City Council v GIO Insurance*** [2003] NSW CA 34) and the subsequent business practices of insurers in removing contractual deeming provisions from their policy wordings.

The objective of the Panel's amendments to Section 54 was to ensure that it *"operates in a consistent manner to all contracts of liability insurance such that the provision of this type of insurance within Australia remains attractive now and into the future"*.

The Draft Bill provides:

1 a new definition of "claims made and notified" policies (s40(1));

2 allows an insured a statutory extended reporting period of 28 days after the expiry of the policy period in which to notify the insurer of facts that may give rise to a claim (s40(3)); and

3 at least 14 days prior to expiry of a claims made and notified policy, an insurer has an obligation to inform the insured of the consequences of failing to notify facts that may give rise to a claim (s40(4)). That notice can be undertaken at the same time as the insurer's notification of expiry of a contract pursuant to Section 58.

DIRECT RIGHT OF ACTION AGAINST INSURERS

The draft bill extends the rights of a third party to bring a direct action against insurers in respect of an insured's liability to that third party. Previously such a right was confined to circumstances where the insured had died or cannot be found. The Draft Bill now permits a direct action to be brought against the insurer where:

1 the insured has been held liable in damages to another person;

2 the judgment has not been satisfied; and

3 the insurance contracts provides insurance in respect of the insured's liability to the third party.

The amendments to Section 51 provide a national basis upon which a third party has a direct right of action against an insurer. Even in those states, such as New South Wales, which have relevant legislation to allow direct claims against an insurer (s6 Law Reform (Miscellaneous Provisions Act) 1946) there has been recent case law as to whether such rights are effective in respect of claims made and notified policies.

SUBROGATION

We have previously had a matter in which we have obtained the opinion of one of Sydney's leading Senior Counsel on the meaning and effect of the existing subrogation provision (s67). That opinion was to the effect that the present subrogation provision is poorly drafted and ambiguous. We therefore welcome the proposed rewording of s67 which appears to provide a clear formula for the distribution of funds recovered in a subrogated action. However section 67 is subject to any express agreement to the contrary which is either contained in the relevant policy or has been entered into by the parties subsequent to the loss.

The new formula essentially provides that the cost of undertaking the recovery action is to be first deducted from the amount recovered and is to be paid to the party who funded that recovery (or shared proportionally between the contributing parties). The funding party has a priority over the proceeds of the recovery to the extent of its liability (in addition to the cost of recovery). The balance is paid to the non-funding party.

Where the proceedings are jointly funded, the parties' relative entitlements are calculated on a pro-rata basis in proportion to the parties' contribution to the funding of the subrogated recovery action.

ELECTRONIC COMMUNICATION

In order for the operation of the ICA to be commensurate with modern commercial practices it is now permissible for insureds and insurers to send each other electronic notices required by the ICA. The draft proposals contain particular safeguards including:

1 requirements as to clarity;

2 the consent and nomination by the recipient of an information system for that purpose;

3 the ability to print and retain the communications;

4 the notice must not incorporate any image, message, advertisement or other feature that distracts or interferes with the understanding of the notice; and

5 the notice must be presented in the way that would reasonably be expected to enable the recipient to readily be able to scroll through the whole notice or document.

CONCLUSION

The ICA is over 20 years old and it appears to be have been successful in its stated purpose of reforming and modernising the law so that a "fair balance is struck between the interest of insurers, insureds and other members of the public" (Preamble to the ICA). It is notable that the UK is proposing to incorporate additional insurance provisions including its own version of Sections 28 and 54.

There are a number of inconsistent judicial interpretations of certain provisions of the ICA which necessitate the draft reform package and as whole we consider that the draft reform package adequately addresses the majority of the identified issues. It is notable that the proposed draft bill has arisen from a two year consultation process involving all aspects of the insurance industry and has thereby benefited from adopting a consensus view to the various concerns expressed by insureds, insurers and insurance intermediaries.

However we believe that some of the proposed provisions, in particular in relation to jurisdiction (s9) and uniformity of insurers' rights regarding non-disclosure/misrepresentation (S31) are too broad and equate to a sledgehammer being applied to crack a nut. We await to see the final version of the Bill and then only time will tell as to whether it successfully addresses all the intended issues.

The Commonwealth Government has identified incorporating the final bill in the list of legislation proposed for introduction later in 2007. As some of the ICA's provisions are effective immediately upon Royal Assent being granted, it is extremely important for all members of the insurance industry to be aware of the effect of the final changes in good time prior to the Royal Assent.