"Claims Made" Policies in Australia - at the Cross-Roads?

Has anything really changed?

The 27 June 2001 decision by the High Court in FAI v Australian Hospital Care has attracted significant interest from insurers but it has been suggested by others that the law had not really changed since the 1991 decision of the NSW Court of Appeal in the C E Heath v East End Real Estate.

On one view this is correct, as the East End decision was the first to highlight the difficulties created by the application of S.54 of the Insurance Contracts Act to the notification provisions of Claims Made and Notified policies. While the result of the East End decision came as a surprise to some, those underwriters who were aware of the effect of the preceding state equivalents of S.54 (namely of Section 18(1) of the NSW Commercial Transactions (Miscellaneous Provisions) Act 1974 and Section 27 of the Instruments Act (Vic) 1958) were not so surprised. On this basis the decision in FAI v Australian Hospital Care could be regarded as a logical confirmation of the effect of Section 54.

While underwriters of 'claims made & notified' policies were concerned at the result of the East End decision in 1991, they were soon comforted by the outcome of the 1993 decision of the NSW Court of Appeal in FAI v Perry, which limited the effect of Section 54 (on this issue) to the late notification of actual 'claims' made against the insured, as opposed to late notification of facts or circumstances which may give rise to a claim being made against the insured at some time in the future. (Most 'claims made' policies required, or at least permitted, the insured to notify the insurer of facts that might give rise to a claim. These policies also contained a provision – referred to as a 'deeming clause' – which provided that such notification would lock any consequent claim into the policy under which notification was given). Underwriters reasoned that late notification of actual claims was less likely to occur than the late notification of circumstances which might give rise to a future claim (as the insured would be keen to promptly notify the insurer of any actual 'claim' in order to obtain the assistance of the insurer in defending that claim). In any event, for the purpose of Section 54, it would inevitably be the case that prejudice would be easier to establish where actual 'claims' are late notified and inappropriately handled by the insured.

While the potential effect, on Claims Made policies, of the state provisions (ie., S.18 (NSW) & S.27 (Vic)) was apparent in the 1970's, few, if any, insured sought to use these provisions to dispute an insurer's denial for notification outside the policy period under a 'claims made and notified' policy. When the Insurance Contracts Act was introduced in 1986, section 54 effectively replaced these state provisions. The Insurance Contracts Act also introduced Section 40, which effectively endorsed and validated the concept of the 'Claims Made' form of policy. Further, Section 40 also introduced a statutory equivalent of the deeming provision found in most claims made policies. This provision, in effect, required the policy in force at the time of notification of facts that might give rise to a future claim, to cover the claim when it was eventually made, even if the policy under which notification was made had expired. This provision was originally introduced to solve the inequity resulting from the situation where there could be a denial of cover by both the insurer on risk at the time the insured first became aware of a potential claim (the denial based on the fact that there was no cover unless an actual claim was made) as well as by the following insurers who would exclude the claim by reason of that claim arising from a specific potential claim circumstance known to the insured at the policy inception. This would leave the insured falling in a gap between both covers if the insured was aware of a claim circumstance in a specific policy period – but no claim was actually made on the insured until a later policy period. It was to deal with this potential that S 40(3) was enacted.

The enactment of S 40(3) also presented underwriters of 'claims made & notified' policies with an opportunity to limit their exposure to late notified claims. It did this by specifying, within the subsection, the time period in which facts that might give to a claim must be notified if the statutory deeming provision was to benefit the insured. This gave insurers the opportunity of removing the equivalent provisions (upon which Section 54 could operate) from their policy wordings. Few insurers however took this opportunity.

In order for insurers to take effective advantage of that provision, it was necessary to remove from the policy wording all provisions permitting, or requiring, the insured to notify facts that might give rise to a claim within any specified time period – ie all provisions on which S54 could operate. The rationale being that S40(3) provided a statutory entitlement subject to a temporal limitation defined by that section. Further, it was necessary to restrict the definition of 'claims' that would be covered by the operative clause

of the policy to a very narrow definition. The rationale for this was to force as much exposure as possible through the coverage route of Section 40(3) – and conversely as little exposure as possible through the operative clause of the policy – which would, of course, be subject to Section 54 (S 54 operates on the 'effect of the of the contract'). This strategy has now been vindicated by the recent decision of Chesterman J in the QLD Supreme Court in McInally v HTW (2001) QSC 388 (16 October 2001).

What I believe will be seen within the coming months is that all writers of 'Claims Made and Notified' policies in Australia will amend their policy wordings to bring them generally in line with the wording format described above – that is if they have not already done so.

While we await a decision of an appeal court, my personal confident expectation is that the approach to the drafting of Claims Made policies which has been vindicated by the McInally case will ultimately be upheld. My reasons are as follows:

- In so far as the policy only covers "Claims" made against the insured and not claims arising from circumstances known, then in respect of the insured's failure to notify such circumstances, an insurer is not refusing to pay by reason of some act (or omission) of the insured (ie failure to notify the circumstances), as is required by Section 54, but because the insuring clause of the insurance contract simply does not respond to provide cover to claims arising from circumstances notified.
- The insured is given a 'conditional' statutory (ie, extra-contractual) right or entitlement in Section 40(3) of the Insurance Contracts Act. The statutory pre-condition to this entitlement is that the "facts that might give rise to a claim" must be notified in writing to the insurer by the insured "as soon as was reasonably practical after the insured became aware of those facts but before the insurance cover provided by the contract expired".
- The majority High Court judges who gave a joint judgement, in FAI v Australian Hospital Care, (McHugh, Gummow and Hayne JJ) in paraphrasing the wording of Section 54(1), used the words: "… the effect of a contract of insurance *according to its terms*…". The highlighted words are not in the actual section and so the inclusion of these words by the judges seems to imply that they are looking at the effect of the express terms of the contract of insurance rather than any implied terms or, indeed, the effect that some other section of the Act may have to give the insured a conditional statutory right or entitlement.
- Justice Kirby, who was also in the majority (in paragraphs 65 and following of the judgement), indicated that 'claims made' policies are valid forms of policy but that they must be read subject to the Act. He also said in paragraph 73 that "*there is merit in the argument that, as far as its words permit, in the case of claims made policies, S 54 of the Act should be construed to afford the relief contemplated in a way consistent with the maintenance of this type of insurance and not in a way that would be destructive of its availability*.". His comments, in this respect, are consistent with the comments he made in his NSW Court of Appeal judgement in FAI v Perry.
- Section 40(3) of the Act already imposes a statutory temporal limitation on the time during which notification of "facts that might give rise to a claim" can be notified in order to gain the benefit under the section. It would be strange indeed if this section (which is **not** expressed as 'subject to Section 54') could be interpreted in such a way as to have its express words read down by Section 54.
- In this respect it should be noted that the wording of Section 40(3) talks about the fact that this statutory entitlement is subject to advice to the insurer "before the insurance cover provided by the contract expired". The clear implication from these words is that this entitlement within S40(3) is not insurance cover provided by the contract, but otherwise. The clear logical conclusion to this is that as Section 54 deals with "the effect of a contract of insurance", the entitlement under S40(3) is not to be read subject to S54.

If in the end result the courts eventually rule that this approach is unsustainable, (and if there is no amendment to the Insurance Contracts Act, then it is my personal belief that it will not be logically possible to continue to write 'claims made' policies in Australia. If this is correct, then I personally believe that we will almost certainly see the rapid evaporation of virtually all capacity to write professional indemnity, D&O and similar policies in Australia. This is obviously not in the interest of anyone, least of all the Government, which, for instance, is seeking to under-gird the new Financial Services Reform package with the availability of professional indemnity insurance for providers of financial services.

Is it likely that PI, D&O and similar covers could be written on an occurrence basis in Australia?
In the event that superior courts take a contrary approach to that taken by Chesterman J in the Mc Inally case, it would effectively spell the end for 'Claims Made and Notified' policies in Australia. This raises the question of whether it would be possible to write PI, D&O and similar classes on an 'Occurrence' basis. In considering this question, it should be recognised that Australia is only a very small percentage of the overall world insurance market and that most of our capacity to either directly or indirectly (by way of re-insurance) from overseas. In this respect it is not likely that overseas markets will change their approach to writing PI and D&O and similar covers on a 'claims made' basis merely because a country which provides 1.5% of the world insurance premiums will not allow, in their market, such policies to operate as they are intended to operate – and in fact as they do operate successfully elsewhere in the world. In addition, following the September 11 events in the USA, there will be a restriction of insurance capacity world wide. This will have consequential effects on the ability of insurers to consider any such proposition. This is more the case because there are some very valid technical reasons why these covers have traditionally been written on a 'claims made' basis rather than on an 'occurrence' basis.

Apart from the removal of the uncertain IBNR quantification, the certain date of the coverage 'trigger' is often a very potent advantage of the 'claims made and notified' format. The benefits of the claims made & notified form to insured, to insurers and to the public at large is set out below:

Major advantages of Claims Made policies are as follows:

1) <u>To the public at large</u>

More stability and certainty of insurance companies due to:
(a) More certainty of reserving for long tail claims
(b) More certainty in regard to solvency calculations
(c) More certainty in profit and loss calculation
(d) More certainty in taxation accounting
(e) Therefore more public confidence in stability of insurers
(f) More, not less, insurers and therefore competition of those prepared to offer capacity for PI and D&O insurance – due to greater certainty.

2) <u>To Consumers</u>

(a) More confidence as to the adequacy of the amount of cover due to the period of the policy being proximate to the date of the claim (as opposed to the situation with Latent Damage claims attaching to long expired occurrence policies – eg asbestos injury claims and latent damage construction claims such as brick growth and concrete cancer - resulting in inadequate limits due to inflation between the date of the event / occurrence and the date of the claim).
(b) Certainty as to which insurer / policy covers the claim
    (i) Due to certainty of the date when the policy was 'triggered' (as opposed to uncertainty with occurrence type policies due, for instance, to long exposure over a number of years during which a number of different policies may have been in force written by a number of different insurers). As an example with D&O policies, at which date did a board permit a company to trade while insolvent? If the D&O policy was written on an occurrence basis, this is the date the policy would be triggered!
    (ii) Because of the temporal proximity of the issue of the policy to the time of the claim there is less chance of lost records in relation to which insurer was on risk at the time of an event etc
    (iii) Because of the temporal proximity of the issue of the policy to the time of the claim, there is more chance of the insurer still being in existence to cover the claim

3) <u>To Insurers</u>

(a) Knowledge during period of policy cover as to which losses attach to the policy, enabling greater certainty in:

(i) Claim reserve setting (no incurred but not reported – IBNR - claims)
(ii) Future premium setting (extrapolated from the certainty of the quantification of past losses)
(iii) Solvency calculations (based on the certainty of the quantification of past losses)
(iv) Profit & Loss accounting (ditto)
(v) Taxation Accounting (ditto)

(b) Early knowledge of circumstances by insurer allows loss mitigation and early investigation, fact collection. This assists in an early understanding of the claim exposure and more accurate setting of the initial claim reserve.

(c) Higher degree of certainty and stability in determination of liability assumed and therefore premium setting due to:
(i) Knowledge of all claims attaching to past policies (no IBNR)
(ii) Knowledge of legal, social, political, economic environment existing during the period in which the claims are made against the policy (as opposed to occurrence policies in which notification often occurs many years after policy expires)
(iii) Ability to be able to settle claims in a similar legal, economic and inflationary environment as that in which premium was set.

What other options do Insurers of 'claims made' policies have?

The Insurance Council of Australia will be proceeding with a submission to the government requesting an amendment to the Insurance Contracts Act. How successful this will be remains to be seen. While it is felt that there is a strong case for amendment, there have been similar submissions over the last 15 years to no avail. What does give some hope this time, however, is that firstly, the latest decision seems to already be having some real effect on underwriters views about writing this form of cover in Australia; secondly, APRA is very sensitive to the stability and security of insurers and to the availability of insurance; thirdly, a previous response by the Insurance and Superannuation Commission (to one of our previous attempts at amendment) has indicated that the Perry decision provided a 'fair balance' of the interests of insurers and of consumers. This is now not the case following the decision of the High Court in FAI v AHC which over-ruled Perry. Fourthly, amendment would be consistent with the views expressed by the principal author of the Australian Law Reform report, upon which the Insurance Contracts Act was based. His views were adopted and endorsed by Kirby J in FAI v Perry. Kirby J's views in FAI v Australian Hospital Care are consistent with this. Fifthly, it would be in the interest of the government to ensure the continued ready availability of PI insurance which they will be looking for to support the regulation of regulated services such as those provided by financial advisors under FSRA. This avenue of legislative amendment, however, is unlikely to be a short term solution as it is likely to take at least some time to convince the regulators. Once the regulators are convinced it will be necessary to pass amending legislation. With other government legislative priorities, any amendment could not be expected until mid 202 at the very earliest. In the meantime, insurers will need to rely on the McInally decision.

While we have this decision however, it should be appreciated that the decision is only that of a single judge of the Qld Supreme Court. Any different approach by a court in any other Australian jurisdiction, especially that of an appeal court could exacerbate the uncertainty and escalate the crisis. This is because, at the moment, underwriters are clutching on to the approach outlined in this paper in order to justify them continuing, in Australia, to write "Claims Made & Notified" policies.

We live in interesting times and we therefore await the next development in this saga with special interest.

Robert Beaton **LLB., B. Arch., Bsc (Arch), ARAIA, AAII**