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Submissions made by way of response to NSW Law Reform Commission Consultation Paper 17

Third Party Claims on Insurance Money: Review of s 6 of the Law Reform (Miscellaneous Provisions) Act 1946

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1. Introduction and Summary

1.1. The New South Wales Law Reform Commission has issued Consultation Paper No 17: "Third party claims on insurance money: Review of s6 of the Law Reform (Miscellaneous Provisions) Act 1946".

1.2. At its conclusion, the Consultation Paper (at paragraph 1.40) invites written submissions on:

1.2.1. the options available for substantive change to the current terms of s 6; and

1.2.2. any related relevant matter.

1.3. In respect of 1.2.1 above: having considered the matters raised in the Consultation Paper and having undertaken a review of the law and industry practice in the area, this response submits that in respect of the terms of reference set out by the Attorney-General that the current form of section 6 is an area of law fraught with difficulties and problems but that it should not be repealed in toto. It is submitted that the section should be substantially amended for the reasons set out below.

1.4. The authors to this submission suggest a combination of the options set out at subparagraphs 1.38.2 and 1.38.3 of the Consultation Paper: that a new draft of the section retain the thrust and structure of the section but clarify the identified areas of current uncertainty **and** reform areas of the section where section 6 has been identified both in case law and in commentary as being problematic or inadequate. In particular, the authors recommend wording which would allow the most beneficial interpretation and application of the intent of the legislation: recourse by third parties to the proceeds of insurance policies where all necessary requirements have been met.

1.5. Balance, however, must be struck between the rights and interests of the third party/plaintiff claimant and the insurer. In particular, any redraft of section 6 should not alter the rights of the parties to the insurance contract.

1.6. In respect of 1.2.2 above: the submission provides some general commentary in relation to the interplay between the spirit and intent of section 6 and several key pieces of both State and Federal legislation.

2. Common law position

2.1. As a threshold issue, it is submitted that in the absence of any statutory intervention the common law can give rise to significant problems and outcomes which may clearly be contrary to the intended benefits of commercial insurance arrangements. It has long been recognised that section 6 seeks to ameliorate this problem.

2.2. As paragraphs 1.3, 1.4 and 1.5 of the Consultation Paper show, significant problems can arise where a plaintiff brings an action against a defendant who has insurance cover in place which effectively will respond to the plaintiff's claim but where the plaintiff is ultimately not able to access that insurance money due to the fact that the insured is either insolvent or where the insured has acted mala fides in relation to the those insurance monies (i.e. has not passed them on to the plaintiff).

2.3. Such a situation it is submitted clearly requires remedial legislation. There is no good reason in principle where but for the insolvency of the defendant insured the proceeds of any insurance

policy taken out by the defendant to meet this very liability and which would have met the claim should not make their way into the hands of the plaintiff.

2.4. As the Consultation Paper makes clear, the mischief arises because at common law under the doctrine of the privity of contract the plaintiff has no direct right to the insurance policy proceeds as paid or payable to the defendant by the insurer and no right to bring any claim in its own right against the insurer; the plaintiff cannot enforce the contract of insurance.

2.5. The common law position it is submitted requires clear legislative remediation. The issue, of course, is how best this is done. At present the issue is addressed in New South Wales by section 6 of the Law Reform (Miscellaneous Provisions) Act 1946. It is submitted that as has long been noted both in judicial considerations of the section and in commentary on the section, the current form and structure of the section as a general and overarching observation:

2.5.1. is opaque and uncertain;

2.5.2. is in many ways a 'victim of its heritage', being more attuned to past forms of insurance policies and insurance arrangements in place at the time that the provision was originally drafted (e.g. broad form liability and public liability policies);

2.5.3. in the same vein, is more attuned to past (potential) behaviour on the part of insureds no longer overly problematic in the community, such as absconding with the proceeds of insurance policies instead of passing these on the plaintiff/claimants (e.g. most insurance proceeds are no longer paid simply to the insured but direct or through defence lawyers to the relevant claimant);

2.5.4. does not take in to account nor provide for flexibility of application for products of insurance which have been developed and indeed come into significant prominence since section 6 was introduced (e.g. Directors' & Officers' insurance and the claims made/claims made and notified form of policy wording now quite common to professional indemnity polices);

2.5.5. does not 'sit well' with either the treatment (or lack thereof) of the problem in other states or with limited Federal legislative provisions in related areas, leading to problems of territoriality, potential forum shopping or different outcomes of differing benefit to the applicants depending upon in which jurisdiction the matter is addressed (e.g. state or Commonwealth).

2.6. It is submitted that the section calls for comprehensive amendment. We detail our particular significant concerns with the provisions and application of the current form of section 6 in our paragraph 3 as follows.

3. Specific comments on current state of Section 6 and major problems with the Section: suggested answers and new framework

3.1. **Need for clarity: current section is unclear.** We agree with all of the issues raised in the Consultation Paper No 17 from paragraph 1.19 to paragraph 1.23 and would add our own comments on further areas of uncertainty and ambiguity in the current form of section 6.

3.2. **Requirement for leave of the Court.** Save for formal solvency administration as set out in paragraph 3.11 to 3.15 of these submissions, we agree that any new legislative provision should require the leave of the court for the plaintiff/applicant to proceed against the insurer. Given that the agreement in issue is the contract of insurance as in place between the defendant and the

insurer, we believe it critical that at the time of the plaintiff's application the insurer have a right to be heard on relevant issues, especially on rights and obligations due and owing under the contract of insurance. In this last regard, we submit that it is fundamental to any arrangement proposed as an amendment to the current structure of section 6 that that arrangement must not alter the rights and obligations of the parties to the insurance contract. We consider this issue further below.

3.3. **Consideration of the nature of the charge the subject of the section: a charge over money or, more correctly, a charge over rights?** We agree that the appropriate mechanism to secure access to the benefit of the relevant insurance policy is through a charge. We believe that confusion and uncertainty can arise when the section is reviewed as to the subject of the charge. We suggest that consideration be given to commentary made by Kelly & Ball, *Principles of Insurance Law* where the authors state that the charge should attach to **any rights** which the insured has that arise at any time after the events that give rise to the claim occurred. (See Kelly & Ball, *Principles of Insurance Law*, LexisNexis, at 6.0060.1.)

3.4. **The most beneficial meaning and application possible**, we submit that any new form of the section should have as wide an application as possible and be framed in such a way as to allow for a comprehensive and beneficial reading and application of the section rather than a narrow construction. In this regard, we submit that any construction of the section should follow the reasoning and application of a kind identified in *FAI General insurance Co Ltd v McSweeney* (1997) 10 ANZ Ins Cases 61-400, rather than the much more narrow approach taken in *Manettas v Underwriters at Lloyd's* (1993) 7 ANZ Ins Cases 61-180 and subsequent cases which follow this line of authority.

3.5. **Clarification that the section excludes defence costs under D&O policies.** The current section 6 is unclear and ambiguous in relation to the relatively modern insurance product, the Directors' & Officers' insurance. In this regard, we submit that any new legislative provision should clearly ensure that the section is **not** applicable to defence costs often provided as part of the D&O policy and is only in respect of an amount equal to or commensurate to the insured's liability to pay damages or compensation to the third party claimant. The relevant charge should **not** attach simply to **all moneys** that might be payable under the D&O contract of insurance. In this regard, it is submitted that the provision should clearly support the view of the New South Wales Court of Appeal in *Chubb Insurance Company of Australia Ltd v Moore* [2013] NSWCA 212 and completely disregard the view put forward by the New Zealand Supreme Court in the decision of *BFSL 2007 Ltd v Steingold* [2013] NZSC 156.

3.6. **Modernisation of the section: clear application to claims made/claims made and notified policies:** a large part of the problem with the current form of section 6 is due to its "age". The section was framed by the legislature at a time when the predominant forms of policies of insurance were in respect of somewhat straight forward first party or third party losses. A dominant form of wording now in use in the commercial market is the claims made/ claims made and notified contract of insurance. It is of particular relevance to the professional indemnity market. These forms of wording are generally triggered on a clams made basis and can provide cover to the insured in relation to events which occurred well **prior** to the commencement of cover. As has long been noted, this can cause significant problems for the current form of the section, and cases have held that there is no application of section 6 in the circumstances of a claims made policy where the event occurred prior to the inception of the policy (see for example and in particular *Owners – Strata Plan 50530 v Walter Constructions Limited (in liquidation)*

[2006] NSWSC 552. This position should be addressed and it is submitted that the section should be expressed so as to make it clear that the section:

3.6.1. does apply to claims made/claims made and notified policies;

3.6.2. does apply even in circumstances where the events in issue took place before the commencement of the policy.

3.7. **Consideration of 'future forms' of policy wordings:** as has been identified above, section 6 has often been criticised as not being able to accommodate types of insurance arrangements which have emerged since the introduction of the section and which may have been unforeseen at that time. To the extent possible, any redraft of section 6 should have an eye to the future or an ability to the extent possible to deal with emerging or future risks. In this regard, we note the very recent emergence or identification of 'cyber risk' and the challenges posed to insurers in constructing policies of insurance which can respond to both first and third party losses in this space. We note that cyber risk has been identified as a significant risk of the immediate future on an international level (see, for example, Lloyd's Report: A Quick Guide to Cyber Risk, 9 April 2015, www.lloyds.com/news/cyber)

3.8. **Intent of the section should also apply to reinsurance arrangements**: any new formulation of section 6 it is submitted should make it expressly clear that the section covers situations where an insured cannot recover against an insurer but seeks to 'cut through" as against the insurer's reinsurer to the extent that it can be said that the reinsurance arrangement indemnifies the cedant "against liability to pay any damages or compensation". Careful drafting may be required in this regard to take account of different forms of reinsurance arrangements such as excess of loss and quota share. Again, the section should not alter the rights of the parties to either the insurance **or** the reinsurance contract.

3.9. **Preservation of insurer's rights as against the insured: need for care:** as we have stated several times above, it is submitted that any new form of section 6 must not alter the rights of the parties to the contract of insurance. Special consideration should be given to the extent of such rights of the insurers. Clearly, the insurer should have an entitlement to rely upon any right it may have against the insured in relation to **pre-contractual matters** such as non-disclosure or misrepresentation or breach of the duty of utmost good faith (prior to inception). Special care should be given, however to the extent that insurers may be able to challenge the insured's entitlement to cover due to matters arising during the policy period. By way of an extreme example: insurers should not be permitted to seek to exclude cover to an insured for failing to cooperate or assist with a claim – due simply to the fact that the insured is deregistered or insolvent.

3.10. **Insurer must be able to raise defences open to the defendant/insured especially in situations of insolvency and the like:** any new draft of section 6 must also ensure that the charge identified only attaches or descends upon only those **actual** insurance moneys that are or become payable in respect of the insured's liability pay damages or compensation. In this regard, the insurer must have an opportunity to determine if the insured has open to it any defences to the plaintiff's claim that may limit or restrict that ultimate liability. Special mention is made is this regard to matters relevant under the *Civil Liability Act (NSW) 2002,* for example Part 1A, Divisions 4, 5 and 8 and, especially Part 4 in relation to proportionate liability.

3.11. **Matters of insolvency: Present position:** As the Consultation Paper refers to at paragraphs 1.25 to 1.29, there are statutory provisions in place effectively allowing plaintiffs with claims on distressed entities to "cut through" the privity of contract between the entity and the insurer by

obliging the appointed insolvency practitioner to remit the net proceeds (i.e. after deducting incurred costs involved in the recovery process) to the claimant /plaintiff. Those sections are section 117 Bankruptcy Act 1966 which applies to trustees in bankruptcy, and sections 562 (as to insurance proceeds) and 562A Corporations Act 2001 (as to reinsurance proceeds),which apply to liquidators. We fail to see why those sections should be limited to those categories of insolvency practitioners. In our view, there are no sound policy reasons as to why a trustee of a Personal Insolvency Agreement under Part X Bankruptcy Act, or voluntary administrators, administrators of deeds of company arrangement, provisional liquidators and receivers of companies under the Corporations Act should not also be covered by the respective legislation

3.12. **Suggested change to Section 6:** Insolvency practitioners frequently encounter fundamental threshold problems, including:

3.12.1. an absence of adequate funds available to bring actions, or investigate adequately, the entity's affairs for the benefit of its creditors;

3.12.2. a lack of cooperation from directors /company officers or bankrupts; and

3.12.3. an absence of adequate documentation in the distressed entity's possession.

3.13. Frequently the insolvency practitioner, as a plaintiff, will consider bringing an action against a defendant who may have insurance for the claim. However, the insolvency practitioner will need to expend money, in the context of its scarcity, in ascertaining whether insurance is available, or be dependent on the insured to make a claim on the insurer when he /she is on notice of a claim on him /her by the insolvency practitioner. At present, if the information or cooperation is not otherwise available, the insolvency practitioner must expend funds in a compulsory public examination Court process to ascertain insurance information, including by serving notices to produce policies in those proceedings on potential insurers or insurance brokers. The practitioner is also entitled as part of the examinable affairs of the insolvent entity to ascertain from insurance representatives, through the compulsory examination process, whether insurance indemnification ought be granted.

3.14. Thereafter to bring a claim on the insurer under section 6 of the Act, the insolvency practitioner plaintiff must then seek leave to proceed under section 6 (4) against the insurer i.e. he/she must expend further funds and incur professional costs, to the detriment of creditor returns, by

initiating in a Court the leave application. This also exposes the practitioner to adverse costs orders if unsuccessful.

3.15. We suggest in the context of formal insolvency administrations that if the insolvency practitioner believes that a potential defendant has insurance from a potential insurer that the practitioner can serve notice on that putative insurer to produce to him/her within, say 28 days:

3.15.1. a copy of any policy, including all terms and exclusions, that may apply to the relevant claiming event. (This would obviate the need for costly investigative/examination procedures); and

3.15.2. whether insurance will be extended or not under that policy; and

3.15.3. if insurance would be declined, the reasons for the declinature. (These last two are matters which would otherwise likely have been dealt with in a section 6(4) application).

3.16. The insolvency practitioner can then make an informed call, without undue expense, as to whether to initiate the action or not against the defendant by having ascertained the existence or otherwise of insurance on the claim. If he/she disagrees with an insurer's decision to decline the claim he/she can join the insurer to the action by seeking a declaration that the policy operates to cover the claim, as occurred in the recent High Court decision of CGU Insurance Ltd v Blakeley [2016] HCA 2 at pars 60 to 70. The potential of personal adverse costs risks on the insolvency practitioner, combined with the ability in appropriate cases to seek security for costs throughout the action, means that practitioners will not bring actions against insurers frivolously or without a reasonably arguable basis. (There could also now be available adverse costs order insurance).

3.17. **Matters relating to Commonwealth legislation:** As we consider there is a good commercial basis for a modernised equivalent to section 6, that should be in the form of uniform national legislation to prevent forum shopping. There is no good policy basis for the legislation to be limited to one, or a handful of, State(s) or Territories.

4. Related matters

4.1. In our submission the approach recommended in this submission is the preferred approach for New South Wales. We can see no good reason why this approach would not also be adopted across the Commonwealth and would recommend that a provision such as section 6, amended as per the above submissions, ought be enacted by the Commonwealth by way of amendment to the Insurance Contracts Act.

4.2. We recognise that achieving this outcome would involve considerable discussion and delay and would not recommend that reform of section 6 in New South Wales be delayed whilst the prospects of uniform national legislation in this area is explored.

5. Summary and Conclusion

5.1. In our submission, the policy behind a revised section 6 should be to recognise that a company or an individual pays a premium to protect itself from an insured risk. If that risk arises the insured (and its secured or general creditors) benefit from the insurance which the insured has paid the premium for, in the sense that the insured's assets are protected from having to meet

the insured claim – the insurance company pays that insured claim (assuming the Policy responds).

5.2. The proceeds of the insurance should go to the third party claimant and that third party claimant should then no longer have a claim against the insured (assuming the Policy limit is sufficient to pay the entire claim and the insurer has no legitimate ground to decline to pay the claim). In the case of a solvent insured, on this basis, the insured and its creditors (other than the third party who has a claim for which the insured is insured) do not receive any of the actual cash coming in from the insurer.

5.3. In our submission, the position where the insured is solvent or insolvent the result should be essentially the same. Where the insured is insolvent, the insured and its creditors benefit from the insurance by removing from the pool of creditors, which share pari pasu in the unsecured assets of the insured, the third party claimant whose claim is instead met by the insurance company. In this scenario the third party has a direct interest in proving the claim and in seeking to ensure that the insurance company pays out on the claim.

5.4. Again, in our submission, this result is fair and equitable for all. In our submission, it is reasonable that the third party who suffers the insured loss should benefit from the insurance recovery because, were it not for the loss suffered by the third party, there would be no insurance money coming into the company. An alternative arrangement in which, in an insolvency, the insurance proceeds were to be accessible for distribution to all the creditors (in effect then most of the proceeds would go to the secured creditor(s)) or all the unsecureds pari pasu, would, in our submission, produce a result that is inequitable and unfair. In this scenario the creditors who did not suffer any loss by reason of an insured event occurring would then gain the benefit of insurance proceeds only made available because the third party has suffered a loss.

5.5. Further, in our submission, the guiding principle behind a revised section 6 should be that the properly recoverable insurance monies are paid to the third party that suffered the real loss and, so far as practically possible, any risk of the interception of the insurance proceeds by the insured company is to be avoided.

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