Australian Law Reform Commission submission to Review of the *Insurance Contracts Act 1984* (Cth) Issues Paper on Section 54

The Australian Law Reform Commission (ALRC) makes the following submission in response to the Department of Treasury's Review of the *Insurance Contracts Act 1984* (Cth) Issues Paper on Section 54.

The ALRC would like to highlight, for the information of the Review, our previous work on insurance contracts (completed in 1982), and the more recent ALRC review of the *Marine Insurance Act 1909* (completed in 2001).

Inquiry into Insurance Contracts

In September 1976, the ALRC was asked to investigate the laws surrounding insurance contacts. The inquiry was conducted in two parts. The first addressed contractual issues and the second covered miscellaneous insurance issues. An Issues Paper (IP 2, 1977) and a Discussion Paper (DP 7, 1979), both titled *Insurance Contracts*, were released for public comment. Relevant extracts from IP 2 and DP 7 are attached.

ALRC 20 Insurance Contracts

The inquiry into insurance contracts was completed with the release of the final report, ALRC 20 *Insurance Contracts* in 1982. The report contains over 70 recommendations aimed at balancing the economic costs of reform and the importance of ensuring fairness in the relationship between insurer and insured. The principal recommendation was the introduction of a new scheme of uniform national legislation. The report included a draft Insurance Contracts Bill, together with explanatory notes. The relevant report chapters, draft Bill and explanatory notes are available online at <http://www.austlii.edu.au/au/other/alrc/publications/reports/20/>.

Chapter 8 of ALRC 20 considered a range of possibilities for reform of the law of general insurance relating to breaches of warranties and conditions in insurance contracts. It was recognised that the law—which still applies in relation to contracts of marine insurance (see discussion below)—could operate inequitably in that a breach of a term may lead to the termination of the contract regardless of whether the insurer was prejudiced by the breach.[1]

The options canvassed by the ALRC included two approaches which preserved the insurer's right to terminate the contract but restricted the circumstances in which that right might be exercised, and two others that involved abolition of the right to terminate, the insurer being left with a right to damages.[2] The options in the first category were the following:[3]

- The right to termination might be limited to cases where the insured's conduct caused or contributed to the relevant loss. This approach is adopted by the *Insurance Law Reform Act 1977* (NZ), s 11.
- An insurer could be prima facie entitled to reject a claim for breach of warranty, but the insured entitled to recover the loss on proof either: (i) that the warranty was intended to reduce the risk of a particular type of loss, different from the type of loss that actually occurred, or (ii) that the insured's breach could not have increased the risk that the loss would occur in the way in

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1 Explanatory memorandum to the *Insurance Contracts Act 1984* (Cth); *East End Real Estate Pty Ltd v CE Heath Casualty & General Insurance Ltd* (1991) 25 NSWLR 400, 404.

2 Australian Law Reform Commission, ALRC 20 *Insurance Contracts* (1982), Australian Government Publishing Service, Canberra, [224].

3 Ibid, [225].

which it did occur. This approach was recommended by the UK Law Commission in its 1980 report.[4]

The second category involved abolishing the right to terminate and substituting a right to damages, assessed in accordance with either:

- the principle of proportionality;[5] or
- by reference to whether the insured's breach caused or contributed to the loss.

The ALRC concluded that a test based on causation, whether formulated as a limitation on the right to termination or as the criterion for the award of damages, is clearly preferable where the insured's conduct is of a type that may cause or contribute to a loss.[6] However, the ALRC noted that such an approach would deprive the insurer of all remedy where there is merely a statistical correlation between the conduct and an increase in the risk. In these circumstances, therefore, acceptable underwriting practices would be seriously inhibited.[7]

In this context, the ALRC referred to warranties concerning unlicensed motor vehicle drivers, named drivers, and drivers under a particular age. While the UK Law Commission's test would overcome the problem, the ALRC concluded that it would do so at the price of doing serious injustice to some insureds where the remedy of termination would be seriously disproportionate to the harm caused by the insured's breach.

The ALRC concluded that the only satisfactory solution involved a combination of two tests: (a) a test based on potential causation (to determine whether the insurer may terminate the contract) and, (b) where termination is not available, an insurer's right to damages, exercisable by way of reduction of the amount payable in response to a claim.

> Where the conduct of the insured might, in principle, have caused or contributed to the loss, a causal connection test should be adopted. As between termination and damages in these cases, there may not be a great deal to choose. But damages provide a more flexible remedy in those rare cases where the insured's conduct caused or contributed to only a part of the loss. Given the insured's superior knowledge concerning the circumstances of most losses, he should bear the burden of proof. Where the insured's conduct could not, in principle, have caused or contributed to the loss, the insurer should also be limited to a right to damages. Those damages should be assessed by reference to ordinary contractual principles. That would, presumably, involve an application of the principle of proportionality … The actual test should be stated in terms of prejudice to the insurer.[8]

This position was incorporated into the draft Bill (clause 54), and was enacted as section 54 of the *Insurance Contracts Act 1984* (Cth).

ALRC 20 also includes some discussion of claims-made policies. In chapter 3, the ALRC concluded that additional cover of the type provided by claims-made-and-notified policies should be made mandatory by legislation. This recommendation was subsequently reflected in s 40 of the

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4 UK Law Commission *Insurance law — Non-disclosure and Breach of Warranty Law* Comm No 104 1980 [10.36].

5 In this context, the 'principle of proportionality' is taken to refer to the approach to remedies for non-disclosure where an insurer is obliged to pay the proportion of the claim which the actual premium paid bears to the premium which would have been payable if the material facts had been disclosed: see Australian Law Reform Commission, ALRC 20 *Insurance Contracts* (1982), Australian Government Publishing Service, Canberra, [188] and [226]. Adopting this principle to remedies for breach of warranty would mean that an insurer would be obliged to pay the proportion of the claim which the actual premium paid bears to the premium which would have been payable if the insurer had known that the breach of warranty would occur. However, the term 'proportionality' is also commonly used to refer to where the insured may recover only that part of the loss that was not caused by the insured's breach of warranty; for example, the *Insurance Contracts Act 1984* (Cth), s 54(4).

6 Australian Law Reform Commission, ALRC 20 *Insurance Contracts* (1982), Australian Government Publishing Service, Canberra, [228].

7 Ibid.

8 Ibid.

Insurance Contracts Act 1984.[9] Chapter 3 of the ALRC 20 is available online at <http://www.austlii.edu.au/au/other/alrc/publications/reports/20/>.

Review of the *Marine Insurance Act 1909* (Cth)

The ALRC's review of the *Marine Insurance Act 1909* (Cth) (MIA) commenced in January 2000.[10] The terms of reference for this inquiry required the ALRC to review the MIA, taking into account, among other things, the desirability of having a regime consistent with international practice in the marine insurance industry, and whether any change might result in a competitive disadvantage for the Australian insurance industry.

A Discussion Paper, *Review of the Marine Insurance Act 1909* (DP 63), was published in July 2000. Four areas came to be of central importance during the course of the review:

- the coverage of the MIA;
- warranties and other statutory provisions with similar effect;
- non-disclosure, misrepresentation and the obligations of utmost good faith;
- and the requirement for an insurable interest.

ALRC 91 Review of the Marine Insurance Act 1909

The final report, *Review of the Marine Insurance Act 1909* (ALRC 91) was tabled in federal Parliament on 22 May 2001. Chapter 9 of the final report on warranties includes a discussion of a number of legislative models, including section 54 of the ICA (see paras 9.62-9.129, attached).

A fundamental feature of marine insurance warranties is that they must be complied with exactly, otherwise the insurer is discharged from liability. If a warranty is breached, even if the subject matter of the warranty is irrelevant to the loss, the insurer is automatically discharged from all future liability.[11] The insurer does not have to elect to avoid further liability although it can waive its rights.[12] Any liability that already has arisen remains on foot. There is no requirement that the breach be connected in any way with any subsequent claim. Trivial or inadvertent breaches are sufficient to trigger the insurer's discharge of liability. The breach cannot be remedied.[13] The rules of strict compliance apply to both express and implied warranties. The MIA does provide several—limited—situations where a breach of warranty will be excused.[14] In addition, an insurer may waive a breach of warranty.[15]

Within the framework of general contract law, the breach of a marine insurance warranty under the MIA may be considered to be analogous to the breach of an essential term (breach of condition) or a breach going to the root of the contract (fundamental breach)[16]—although termination is automatic rather than by election. The different use of the term 'warranty' in marine insurance law as compared with general contract law is well established, but potentially confusing or misleading. The term is not used in the *Insurance Contracts Act 1984* except to negate the existence of warranties.[17]

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9 Ibid, Summary of Recommendations, [40]; Appendix A—Draft Insurance Contracts Bill 1982, cl 41.

10 The inquiry was originally to be undertaken by the Commonwealth Attorney-General's Department. Following the publication of a brief Issues Paper, and a period of inactivity, the inquiry was referred to the ALRC.

11 MIA, s 39(3).

12 MIA, s 40(3).

13 MIA, s 40(2): 'Where a warranty is broken, the assured cannot avail himself of the defence that the breach has been remedied, and the warranty complied with, before loss.'

14 MIA, s 40(1).

15 MIA, s 40(3).

16 See N Seddon and M Ellinghaus *Cheshire and Fifoot's Law of Contract* (7th Aust ed, 1997), 742.

17 See *Insurance Contracts Act 1984* (Cth), s 24.

In DP 63, the ALRC noted that criticism focused on the operation of the warranty provisions under which the insurer may, subject to any express contrary provisions in the policy, avoid all liability from the date of the breach of a warranty regardless of whether the breach was material to the loss, the state of mind of the insured or whether there was any causal connection between the breach and the loss. Submissions received in response to DP 63, including those from insurers, expressed considerable support for reform in this area.[18]

Legislative models for reform

The ALRC noted that there were many potential options for reform of the law relating to marine insurance warranties. Generally, these approaches provide for the introduction of elements of causation or materiality so that, for example, an insurer may only avoid liability for breach of warranty where the warranty was not remedied before the loss occurred or where the breach caused or contributed to the loss. In some cases, a distinction is drawn between express warranties in the policy and the warranties implied by statute. Possible models for reform included:

- Section 11 of the *Insurance Law Reform Act 1977* (NZ);[19]
- Section 18 of the *Insurance Act 1902* (NSW);[20] and
- Section 54 of the *Insurance Contracts Act 1984* (Cth).[21]

Section 54 of the Insurance Contracts Act 1984

Chapter 9 of ALRC 91 includes a lengthy discussion of s 54. The ALRC noted that the question concerning the categories of act or omission covered by s 54 had been a matter of some legal controversy.[22] The discussion noted:

- the effect of s 40 of the *Insurance Contracts Act 1984*;[23]
- a summary of relevant case law on s 54;[24] and
- a summary of the considerable critical analysis by legal commentators that has focussed on the implications for claims-made policies.[25]

ALRC's conclusion

The ALRC concluded that the concept of warranties, both express and implied, as used in the law of marine insurance should be abolished and replaced with a system permitting the subject matter currently covered by them to be dealt with by express terms of the contract. Except as provided by the Act as amended[26] and subject to the terms of the contract, a breach by the insured of an express term (including those replacing warranties) should entitle insurers to be relieved of liability to indemnify the insured for a loss where the breach is causative of that loss.[27] Such a reform generally

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18 Australian Law Reform Commission, ALRC 91 *Review of the Marine Insurance Act 1909* (2001), Australian Law Reform Commission, Sydney, [9.114]–[9.117].

19 ibid, [9.53]–[9.57].

20 ibid, [9.58]–[9.61].

21 ibid, [9.62]–[9.129].

22 See, for example, *Greentree v FAI General Insurance Co Ltd* (1998) 158 ALR 592.

23 Australian Law Reform Commission, ALRC 91 *Review of the Marine Insurance Act 1909* (2001), Australian Law Reform Commission, Sydney, [9.81]–[9.88].

24 See ibid, [9.89]–[9.99]. The decision of the High Court in *FAI General Insurance Co Ltd v Australian Hospital Care Pty Ltd* (2001) 204 CLR 641 and the decisions of the New South Wales Court of Appeal in *Gosford City Council v GIO General Limited* [2002] NSWSC 511 and [2003] NSW CA 34 were not available when ALRC 91 was prepared.

25 Australian Law Reform Commission, ALRC 91 *Review of the Marine Insurance Act 1909* (2001), Australian Law Reform Commission, Sydney, [9.100]–[9.102].

26 See ibid, recommendation 14, which provides that the MIA should be amended so that where the insured is in breach of an express contractual term to the effect that, so far as the insured can control the matter, the insured adventure shall have no unlawful purpose, the insurer is discharged from all liability under the contract.

27 See ibid, Recommendation 7. Other recommendations are directed at the warranty of seaworthiness, the warranty of legality and change of voyage.

would be in conformity with international practice—certainly in civil code countries and in some common law jurisdictions, whether as a result of statutory reform (as in New Zealand) or judicial interpretation (as in Canada).

In rejecting s 54 as a model for reform of the MIA, the ALRC stated that, in important respects, the practical effect of the operation of s 54 is to allow the insured to unilaterally alter the bargain made by the parties, arguably to the extent of fundamentally changing the scope of the insurance.[28] While the insurer's liability may be reduced to the extent of the prejudice it suffers, even to zero, the room for dispute over whether or not a particular marine insurance claim is payable, and the extent to which it is payable, would be greatly expanded.

A related objection to the ICA model is the element of proportionality it introduces.

> This approach may lead to practical difficulties in quantifying an insurer's liability. Concerns have been expressed about resultant uncertainty and the cost of litigating disputes about quantification of liability under a proportionality principle.[29]

During consultations as part of the MIA inquiry, the ALRC consistently heard that adopting the ICA s 54 formulation of causation, which refers to acts 'causing or contributing to a loss',[30] would be overly prejudicial to the insured. The insurer might be entitled to avoid liability if there was any connection between the breach of warranty and the loss.[31]

For example, Alexander Street SC submitted that the insurer should only be entitled to avoid for a breach that was a proximate cause of the loss and that the notion that there may be dual or multiple proximate causes should be expressly recognised. He added that

> the proportionate diminution of insurer's liability by a reason of a breach with indirect causal effect or contribution to the loss is a recipe for unmeritorious pressure to be exerted by the insurer on the insured.[32]

The ALRC agreed that an insurer should be able to avoid liability only where the loss in respect to which the insured seeks to be indemnified was proximately caused by the breach of warranty. Therefore, under the ALRC's recommended reforms, where a breach of warranty is one of several proximate causes of loss the insurer would not be liable, notwithstanding that an insured peril is also a proximate cause.

The ALRC noted that the ICA model has some advantages. Section 54 addresses warranties and all similar contractual terms that allow an insurer to refuse to pay a claim by reason of some act of the insured and, while there has been some uncertainty over its ambit,[33] case law now exists to guide the interpretation of this provision. However, the ALRC ultimately concluded that the ICA reforms do not provide a suitable model for MIA reform. The ICA provisions are broader than necessary to address the deficiencies of the present law of marine insurance. The ALRC was also concerned to keep any amendments within the existing style and structure of the MIA so that it remained consistent with similar international regimes.

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28 See ibid, [9.120].

29 See ibid, [9.121].

30 *Insurance Contracts Act 1984* (Cth), s 54(1)–(2). Kelly and Ball state that there appears to be no significance in the omission of 'contributes' in *Insurance Contracts Act 1984*, s 54(3)–(4): D Kelly and M Ball, *Principles of Insurance Law in Australia and New Zealand* (1991) 272, fn 222.

31 Advisory Committee meeting 18 December 2000.

32 A Street Submission 15.

33 See Australian Law Reform Commission, ALRC 91 *Review of the Marine Insurance Act 1909* (2001), Australian Law Reform Commission, Sydney, [9.77].