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Précis Paper

Interpreting s 54 of the *Insurance Contracts Act 1984* (Cth)

This presentation discusses recent developments in insurance law and the engagement and application of s 54 of the *Insurance Contracts Act 1984* (Cth).

Discussion Includes

- History and development of s 54, Insurance Contracts Act 1984 (Cth)
- Review of recent authorities
- Balancing the interests of the insured and the insurer
- The engagement of s 54
- Drafting policies to avoid the risk of activating s 54
- Identifying the relevant "act or omission" under s 54
- The role of s 54 in a contribution claim

Précis Paper

Interpreting s 54 of the *Insurance Contracts Act 1984* (Cth)

1. In this edition of BenchTV, Tim Castle (Barrister – 6 St James Hall, Sydney) and Mark Sheller (Partner – Holman Webb Lawyers, Sydney) discuss the recent decision of the Full Federal Court of Australia, *Watkins Syndicate 0457 at Lloyds v Pantaenius Australia Pty Ltd* [2016] FCAFC 150 ("*Watkins v Lloyds*").

Background and Material Facts

2. Mr Phillips was the owner of a fibreglass yacht insured with the appellant (Watkins). The policy was underwritten by Nautilus Marine Insurance Agency Pty Ltd (Nautilus).

3. On 22 June 2013, the yacht ran aground in Australian waters off Cape Talbot in Western Australia, having returned to Australia from participation in a race from Fremantle to Bali. Shortly before the Fremantle to Bali race, Mr Phillips appeared to recognise that the Nautilus Policy did or may not cover the yacht for the race. After obtaining a quotation from Nautilus on behalf of Watkins for an extension to cover the yacht in the race, Mr Phillips approached other insurers (the respondents) for a second policy which directly covered the race. The second policy written by the respondents (the Pantaenius Policy) covered the loss in terms. Mr Phillips' claim was paid. The respondents then claimed contribution from the appellant.

4. The Nautilus Policy was constituted by Mr Phillips' insurance application, a Certificate of Insurance and a Product Disclosure Statement (the PDS). The Certificate of Insurance contained essential details of the policy including a broad coverage clause, a description of the property covered, premium details and excess details. The Certificate of Insurance stated the "Geographic Limits" to be "250 nautical miles off mainland Australia and Tasmania". Immediately after the essential policy details contained in the Certificate, a number of endorsements and conditions were listed, including the following:

> *This policy is extended to cover you for loss or damage to your boat caused by one of the Insured Events while competing in sailboat races, within the geographical limits of the policy, which do not exceed a distance of 100 nautical miles.*

5. Within the PDS, page 11 contained terms which provided that cover was suspended from the time when a boat cleared Australian Customs and Immigration for the purpose of leaving Australian waters and would recommence when the boat cleared Australian Customs and Immigration on return.

6. In this case, Mr Phillips had cleared Australian Customs in Fremantle in order to participate in the race. On re-entering Australian waters, he radioed Customs and was instructed to proceed to Darwin to clear Customs. The accident in which his ship ran aground and was shipwrecked occurred en route to Darwin. Thus, he had not at that stage cleared Australian Customs on his return trip.

7. Watkins therefore sought to argue that the policy was suspended at the time at which the accident occurred. Pantaenius, in seeking contribution from Watkins under the Nautilus Policy, argued that s 54 of the *Insurance Contracts Act 1984* (Cth) applied and remedied Phillips' failure to clear Customs.

8. At first instance, Foster J found that although it was an intention of the policy to exclude voyages that had an international character (by reference to the PDS), that was not part of the essence of the policy. On that basis, s 54 applied and prevented Watkins from relying upon those provisions suspending the policy.

Section 54 of the *Insurance Contracts Act 1984* (Cth)

9. Section 54(1) provides:

> **Insurer may not refuse to pay claims in certain circumstances**
> *(1) Subject to this section, where the effect of a contract of insurance would, but for this section, be that the insurer may refuse to pay a claim, either in whole or in part, by reason of some act of the insured or of some other person, being an act that occurred after the contract was entered into but not being an act in respect of which subsection (2) applies, the insurer may not refuse to pay the claim by reason only of that act but the insurer's liability in respect of the claim is reduced by the amount that fairly represents the extent to which the insurer's interests were prejudiced as a result of that act.*

10. The section prevents an insurer from denying liability by relying on a breach of a policy condition that occurs when the insured has committed a particular act, error or omission after the policy is entered into and which did not cause the loss or prejudice the insurer's interests.

11. Prior to the passage of the *Insurance Contracts Act 1984* (Cth), the Australian Law Reform Commission published the *Insurance Contracts Report* (Report 20, 1982). That report led to what Mr Castle described as a fairly revolutionary way of thinking about insurance contracts, which sought to balance the interests of the insured and the insurer. During oral arguments in *Watkins v Lloyds*, Mr Castle noted that the Court drew attention to the element of fairness that underpins the analysis of s 54.

12. Courts of all jurisdictions have had cause to consider the scope of s 54 over recent years. Some conflict developed between different Supreme Courts as to the interpretation of s 54, specifically between the Western Australian and Queensland Supreme Courts in *Johnson v Triple C Furniture & Electrical Pty Ltd* [2010] QCA 282; [2012] 2 Qd R 337 and *Maxwell v Highway Hauliers Pty Ltd* [2013] WASCA 115; 45 WAR 297. The High Court went some way to resolving this conflict in *Maxwell v Highway Hauliers Pty Ltd* [2014] HCA 33; 252 CLR 590, and considered the relationship between the claim made and the fundamental limitations of the policy. This issue was also considered by the NSW Court of Appeal in *Prepaid Services Pty Ltd v Atradius Credit Insurance NV* [2013] NSWCA 252. It was against this background that the current dispute arose, which gave the Full Federal Court an opportunity to weigh in on the evolution of s 54.

13. In *Johnson v Triple C Furniture & Electrical Pty Ltd* [2012] QCA 282; 2 Qd R 337, the Supreme Court of Queensland held that s 54(1) was not engaged in circumstances where the insurer, relying on a temporal exclusion, refused to pay a claim. The relevant exclusion provided that the policy would not operate while the aircraft was being operated in breach of the *Civil Aviation Regulations 1988*. The evidence showed that accident occurred at a time when the pilot had not satisfactorily completed a mandatory flight review, in breach of the Civil Aviation Regulations. That being the case, the Court upheld the application of the exclusion and found that s 54(1) did not apply.

14. In contrast, in *Maxwell v Highway Hauliers Pty Ltd* [2013] WASCA 115; 45 WAR 297, in circumstances where a driver who was responsible for an accident had not passed a test required by the insurance policy, the Supreme Court of WA held that s 54(1) was engaged. On appeal, in *Maxwell v Highway Hauliers Pty Ltd* [2014] HCA 33; 252 CLR 590, the High Court considered the nature of the policy. The High Court held that the insurance policy in question (as well as that in issue in *Johnson v Triple C*) was an occurrence based policy, which was its essential nature. In each case, therefore, there was an occurrence – in *Maxwell,* it was a truck accident, and in *Johnson v Triple C*, it was a plane accident. Further, in each case, a policy suspension occurred as a result of an act that had taken place after the insurance contract was entered into – the act in *Maxwell* being the driving of vehicles by people who were not properly tested, and in *Johnson v Triple C*, the flying of a plane by a pilot had not passed all of the necessary requirements.

15. For s 54(1) to be engaged, the denial of liability by the insurer must be based upon some act of the insured or of some other person, being an act that occurred after the contract was entered into. Determining that *Johnson v Triple C* was wrongly decided, the High Court said very plainly in *Maxwell* that s 54 applied, and that the lack of a particular quality

attaching to the drivers or pilot was the relevant act or omission that engaged s 54(1). The Court held (at [26]-[27]):

> *"The fact that each vehicle was being operated at the time of the accident by an untested driver is properly characterised as having been by reason of an "act" that occurred after the contract of insurance was entered into. […] it is sufficient to engage s 54(1) that the effect of the Policy is that the Insurers may refuse to pay those claims by reason only of acts which occurred after the contract was entered into."*

16. In contrast, in *Prepaid Services*, credit insurance was provided in respect of particular policies of credit. It was not, therefore, credit insurance generally, but insurance that was specific to certain policies of credit. The NSW Court of Appeal held that s 54 did not apply in those circumstances. The relevant principle was that any claim for indemnity made under an insurance policy is subject to that policy's inherent restrictions and limitations. Section 54 cannot be engaged to remedy any failure by the claim for indemnity to observe those inherent restrictions or limitations, and it is therefore a question of determining what are those inherent restrictions or limitations. Referring to previous decisions, the Court of Appeal referred to "the need to identify any "restrictions or limitations" inherent in the actual claim to an indemnity, by reference to the characteristics of the event or circumstance to which the policy responds" (at 137]).

<u>What was the Insuring Essence of the Policy?</u>

17. In this case, the Court considered the insuring essence of the insurance policy under consideration. Similarly to *Maxwell*, the policy here was an occurrence based policy, whereby Phillips was insuring his boat for any damage that occurred within a 250 nautical mile limit. Moreover, there was an occurrence (the accident) which occurred during a period of suspension brought on by Phillips clearing Customs in Fremantle and not yet reclearing Customs on his return to Australia.

18. It was conceded by the respondent at trial that there was no prejudice to them by virtue of the fact that the accident occurred prior to Phillips reclearing Customs. That is, there was no greater risk profile of the boat merely because it had not yet cleared Customs, and if another boat was travelling along side it that had only travelled domestically, that boat would not be exposed to any less risk on that basis alone.

19. In determining in what circumstances s 54 is engaged, the Court said at [40]:

> *The process of understanding what are the restrictions or limitations that are inherent in the claim is one that involves the construction of the policy, not merely as to what its constituent*

words mean, but in a broad sense so as to characterise as a matter of substance what is the essential character of the policy. Once that essential character is decided upon, the restrictions or limitations that necessarily inhere in any claim under such a policy (to which s 54 does not apply) and the restrictions or limitations that do not necessarily inhere in any claim under such a policy (to which s 54 may apply) can be ascertained.

20. Thus Mr Castle commented on the difference between an orthodox approach to contractual construction and the broader process of construction for the purpose of s 54. If the Court was simply adopting an orthodox approach to contractual construction, they would examine the contract as a whole, namely the Certificate of Insurance plus the PDS. However, in identifying the *essential character* of the contract for the purpose of determining whether s 54 is engaged, the Court adopts a broader approach. The Certificate of Insurance is key to defining the essential character of the policy, in contrast to the fine print contained in the PDS.

21. In *Prepaid Services*, for example, the insurance was credit insurance for a specific class of credit contracts, and therefore s 54 could not be used to bring contracts outside the scope of that class within the policy. By analogy, s 54 could not be engaged to extend coverage of a car insurance policy in respect of Car A to Car B.

22. The Court in *Watkins v Lloyd* went on to hold that the process of characterisation is largely influenced by the expression of the parties in the terms of the insurance policy. Therefore, if Nautilus had truly wished to propound a policy that was only for domestic voyages, it could have said so in simple terms. Instead, the suspension clause's reference to clearing Customs was "more easily seen to be a qualification upon the essential cover, as collateral to the policy's essential character" (at [43]). The judgment therefore brings out an obligation on insurers to make sure that a policy is drafted as tightly as possible in order to mark clear what the inherent restrictions or limitations of the policy are.

23. Invoking the High Court's decision in *Maxwell*, the Full Federal Court ultimately held that in the language of the policy and underlying documents, there was no characterisation that gave the suspension sufficient weight to be treated as an inherent restriction or limitation, and thus s 54 was engaged. The Court stated (at [46]):

The Nautilus Policy provided cover where, as here, the yacht suffered a casualty within its stated geographic limits of 250 nautical miles off mainland Australia and Tasmania. But for the operation of the suspension of cover after the insured's act of causing the yacht to clear Australian Customs for the purpose of leaving Australian waters and the insured's omission to clear Australian Customs after the yacht had re-entered the geographic limits on the return voyage, the Nautilus Policy would have responded to the casualty. The act of clearing

Australian Customs and the omission (as yet at the time of the casualty) on the yacht's return to clear Australian Customs, can each be seen to be an act or omission of the insured that occurred after the inception of the Nautilus Policy, during its period of cover and within its geographic limits. That was sufficient to engage s 54(1) because the effect of the suspension of cover in those circumstances entitled Nautilus to refuse to pay the insured's claim.

The Role of s 54 in a Contribution Claim

24. In this case, Nautilus argued that it was inappropriate for another insurer to take advantage of s 54 in a claim for contribution. By reference to the principle of equitable contribution, the Court held that no overly technical approach should be taken, and found (at [53]):

Here the obligations of the two insurers should be characterised in nature, extent and function as the same. By way of example, could there be any doubt that contribution would lie between two insurers, to both of whose policies s 54 applied in circumstances where neither policy in its strict terms responded and the insured made a claim on one, but not the other, policy?

25. Equitable contribution was designed to avoid arguments of this nature. To prevent one insurer from relying on s 54 in a claim for contribution would mean that it would become a question of which insurer chose to pay the insured's claim that determined whether or not the other insurer is liable. The Court therefore dismissed the appeal on this point also.

BIOGRAPHY

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Tim Castle was admitted as a solicitor in 1992 and called to the Bar in 2013. He is a widely recognised commercial litigation specialist, and acts in complex commercial and financial disputes. Prior to being called to the Bar, he was a partner at Atanskovic Hartnell. He has also worked in the Financial Special Deterrence team at ASIC and in other in-house and private practice roles.

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Mark has over 30 years' experience representing insurers and insured in a wide variety of indemnity and commercial disputes. He has been involved in many of the leading professional indemnity and insurance law cases in Australia. Mark has considerable experience in financial lines insurances, coverage disputes, and drafting and advising on insurance policies.

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Benchmark Link

https://benchmarkinc.com.au/benchmark/insurance/benchmark_10-11-2016_insurance.pdf

Judgment Link

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Cases

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Legislation

Insurance Contracts Act 1984 (Cth)