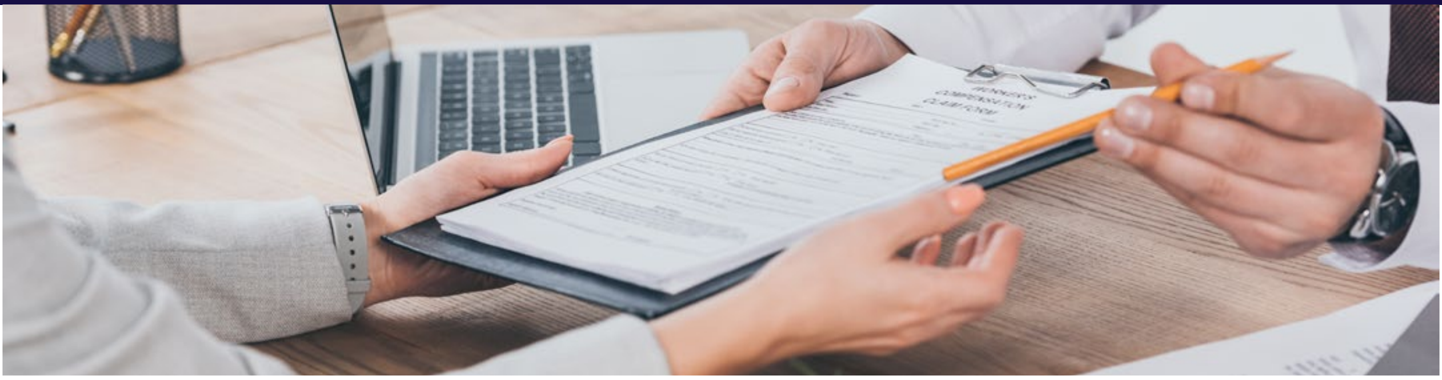
A GUIDE TO THE OPERATION OF CLAIMS MADE AND REPORTED POLICIES



WHY DO WE USE CLAIMS MADE AND REPORTED POLICIES?

An insured accountant provided negligent advice to their client over a period of five years between 2010 and 2015. This becomes apparent to the Insured in 2016, and a claim is subsequently brought against them alleging losses suffered as a result.

During the relevant period, the Insured held Professional Indemnity (PI) policies with a number of different insurers. If cover were provided on an occurrence basis, it would be necessary to ascertain the losses arising from each breach that occurred during the currency of each of the relevant policies. In those circumstances, it is likely that apportionment of loss, and associated legal expenses, between the relevant insurers might be subject to disagreement.

To avoid the complications of apportionment between policies and insurers, PI policies are generally constructed on a 'claims made and notified' basis.[1] The policy purchased each year indemnifies the insured in respect of claims made during that policy period, regardless of the date on which the service or advice (giving rise to the relevant cause of action) was provided.[2]

This approach does however present some challenges. Relevantly, each policy is likely to exclude cover for claims arising from circumstances known to the Insured, or which ought to have been known to the Insured, at the inception of the policy.

YOU CAN'T INSURE A BURNING HOUSE

PI policies generally provide a specific definition of a 'Claim'. More often than not, that includes the commencement of legal proceedings or a written demand for compensation by a third party.[3]

In the above scenario of our accountant, it's possible that circumstances which might give rise to a 'Claim' in the future may have first become apparent during the 2015 to 2016 policy period, but the definition of 'Claim' under the 2015 to 2016 policy might not be satisfied until the 2016 to 2017 period. At renewal in 2016, the insured would be obliged to disclose those circumstances to insurers and, as a result, any claim arising in the future would be excluded from cover under the 2016 to 2017 policy.

SECTION 54 AND ALL THAT

From a practical perspective, an insured that becomes aware of circumstances that might give rise to a claim against them must have the right to effectively notify those circumstances under the policy current at that time. The result being that the policy in force when the circumstances are first notified, responds to any subsequent claim.

Traditionally, the mechanism insurers employed to achieve this was effectively an extension of the policy definition of a Claim to include 'Circumstances' that might give rise to a claim in the future. Often referred to as a 'deeming provision', this created a contractual right to notify Circumstances.[4]

Litigation in the early 2000s (chiefly FAI General Insurance Co Ltd v Australian Hospital Care Pty Ltd[5]) established that courts would interpret section 54 of the Insurance Contracts Act (ICA) to the effect that a contractual right available to an insured party during the currency of a policy could be exercised after the expiry of that policy.[6]

Litigation and other forms of dispute resolution take time to play out and so it may be several years before an insurer can ascertain exactly what losses will be sustained under a single policy. The potential that an expired policy might be triggered by a 'Claim' or 'Circumstance' reported after expiry compounded this problem for insurers.

1 Carter Newell Lawyers, *Professional Liability Guide* (1st ed, 2017) 69, 71.
2 Ibid 69.
3 Ibid 69-70.
4 See Carter Newell Lawyers, *Professional Liability Guide* (1st ed, 2017) 71.
5 [2001] HCA 38.
6 Ibid; Carter Newell Lawyers, *Professional Liability Guide* (1st ed, 2017) 76, 78.

It was not practical to remove the contractual right to notify a Claim as it would render the policy ineffective, that right being central to its operating provision. The statutory right – as opposed to contractual right - to notify facts, which might give rise to a claim, is however provided under section 40(3) of the Insurance Contract Act. Consequently, insurers removed deeming provisions (or provisions of similar effect) from policies, and thereby the contractual right to notify circumstances. Insurers took the view that the contractual right to notify was not necessary as the Insured could rely on its statutory right to notify under section 40(3) of the ICA.

It is however important to note that the statutory right can only be exercised during the currency of the relevant policy, not after expiry. It is also worth noting that section 40(3) of the ICA only applies to a third party loss and not first party such as legal costs incurred in relation to an inquiry for example.

While insurers generally took steps to remove 'deeming provisions' from their policies (to avoid the unfavourable outcome discussed above), courts have also confirmed that, where the policy does not contain a contractual right to notify circumstances as opposed to a Claim, the statutory right under section 40(3) cannot be relied upon in combination with section 54 to cure an insured's failure to notify circumstances.

An insured that becomes aware of circumstances that might give rise to a claim and fails to notify the insurer on risk prior to the expiry of the relevant period is in danger of having any subsequent claim denied. This is a heavy onus on the insured, particularly given the interplay between section 40(3) and the disclosure obligations under section 21 of the ICA.[7] The latter being objective, subjective and retrospective while the former can only be subjective and not retrospective.

WHAT'S A CIRCUMSTANCE?

An accountant plans to retire and is selling his business. As previously referenced, the exposure continues, though the business may not. Prudent advice from his broker recommends that Run-off cover is obtained. Conventionally, such cover is held for a period of seven years. Premiums for run-off policies are often multiples of three to four of the premium paid for the last year of annual cover.

The accountant is reluctant to pay such a premium. He provides a list of *every* client engagement over thirty years of practice to his broker and instructs the broker to notify his current insurer of every engagement prior to the closure of the business.

The accountant takes the view that each client represents a circumstance that might give rise to a claim in the future. Having done so, he considers any claim subsequently arising is to fall for cover within that policy period and as a result, there is no requirement for Run-off cover.

In practice, the insurer will not accept such a notification for obvious reasons.[8] However, the insurer's acceptance or otherwise is not relevant, as the notification stands and falls on whether section 40(3) is satisfied when a claim eventuates. Case law indicates that the Insured is not required to anticipate the precise allegations that might be made against it, nor that the claim would have any merit.[9] It would, however, require a causal link to be established between the facts notified and the claim subsequently arising, and such a broad notification as given in the above example is not reliable.[10]

CONTINUITY PROVISIONS

Insurers have acknowledged the challenges posed to an insured in notifying circumstances by the provision of 'Continuity Clauses' in PI policies.

Continuity Clauses allows the notification of facts that might give rise to a claim *after* the relevant policy has expired if the insurer currently on risk was also on risk at the time the insured ought to, or could have, notified the circumstances. However, cover is restricted to the terms and conditions of the policy in force for the period during which the Insured ought to have notified.

During periods of soft market[11] conditions, some insurers have gone further and provided continuity of cover over a period during which another insurer was on risk.

IMPORTANT NOTES

- Prior to each renewal it's important that the insured identify any claims or circumstances and ensure they are notified under the current policy;
- Policies must extend to cover service or advice previously provided, even if that's no longer the case;
- Retroactive dates have the potential to significantly restrict cover;
- Continuity provisions can operate to forgive the late notice;
- Insured parties need to be mindful of their disclosure obligations when completing proposals; and
- If in doubt, notify any circumstances which might give rise to a claim in the future.

[7] See Carter Newell Lawyers, *Professional Liability Guide* (1st ed, 2017) 91.

[8] Julie Bowker, 'Sections 28(2), 28(3) and 40(3) of the ICA considered', *Publications* (Web Page, July 2021)

[9] See *FAI General Insurance Co Ltd v Australian Hospital Care Pty Ltd* (1999) 153 FLR 448, 451 [10].

[10] See Carter Newell Lawyers, *Professional Liability Guide* (1st ed, 2017) 72–3.

[11] A 'soft market' is often characterised as having lower insurance premiums, broader coverage for insureds, and increased competition among insurers.

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