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# Case Note

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## **The Lesser of Two Evils: *FAI General Insurance Co Ltd v Australian Hospital Care Pty Ltd***

### **1. INTRODUCTION**

The High Court's decision in *FAI General Insurance Co Ltd v Australian Hospital Care Pty Ltd*<sup>1</sup> (*FAI v AHC*) appears to be the "final word" on the operation of s54(1) *Insurance Contracts Act*<sup>2</sup> with respect to "claims made and notified" policies of insurance.

The majority<sup>3</sup> gave the provision a wide interpretation and ended any doubt that the NSW Court of Appeal decision in *FAI General Insurance Co Ltd v Perry*<sup>4</sup> (*FAI v Perry*) was overruled.<sup>5</sup>

In short, the importance of the High Court's decision is two-fold:

- (a) First, to endorse a liberal construction of s 54(1) in line with its previous decision in *Antico v CE Heath Casualty & General Insurance Ltd*<sup>6</sup> (*Antico*), disapproving of attempts to read down the provision through artificial distinctions between "omissions" and "non-actions"<sup>7</sup> or "actions external to the policy"<sup>8</sup>; and
- (b) Secondly, to reformulate the reasoning in *Greentree v FAI General Insurance Co Ltd*<sup>9</sup> (*Greentree*) and *Permanent Trustee Australian & Anor v FAI General Insurance Co Ltd*<sup>10</sup> (*Permanent Trustee*).

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<sup>1</sup> [2001] HCA 38 (27 June 2001).

<sup>2</sup> *Insurance Contracts Act* 1984 (Cth).

<sup>3</sup> McHugh, Gummow and Hayne JJ, Kirby J (Gleeson CJ dissenting).

<sup>4</sup> (1993) 30 NSWLR 89.

<sup>5</sup> *FAI General Insurance v Australian Hospital Care* [2001] HCA 38 (27 June 2001) at para 35.

<sup>6</sup> (1997) 188 CLR 652.

<sup>7</sup> See *Kelly v New Zealand Insurance Co Ltd* (1996) 9 ANZ Ins Cas 61-317.

<sup>8</sup> See *Greentree v FAI General Insurance Co Ltd* (1998) 158 ALR 592 per Spigelman CJ.

<sup>9</sup> (1998) 158 ALR 592.

<sup>10</sup> (1998) 44 NSWLR 186.

## 2. CLAIMS MADE AND NOTIFIED POLICIES

“Claims made and notified” policies were an innovation developed by insurers “to confine the insurer’s liability to those claims which were both made against the insured and notified by the insured to the insurer within the policy period”.<sup>11</sup>

These policies are to be contrasted with “occurrence based” liability policies which provide indemnity for acts occurring within the period of cover subsequently giving rise to a claim.

“Claims made and notified” policies were developed to limit the “long tail” of liability under occurrence based policies, which may arise many years after the policy had expired, thus prejudicing the insurer.<sup>12</sup>

An extension of such policies are “claims made and occurrences notified” or “discovery” policies<sup>13</sup> which :

...include cover in respect of an occurrence of which an assured became aware during the policy period which might give rise to a claim outside that period, where the assured invoked the policy by notifying the insurer of the occurrence during the policy period.<sup>14</sup>

Such a policy arose for consideration in *FAI v AHC*.

## 3. EFFECT OF S 54(1)

Section 54(1) provides that an insurer may not refuse to pay a claim by reason only of an act of an insured or another person which would (apart from s54(1)) give rise to a right in the insurer to refuse the claim. However, the insurer’s liability is reduced by the extent to which the insurer is prejudiced. Section 54(6) provides that “act” includes an “omission”.

It is now settled that in respect of “claims made and notified” policies, s54(1) operates to cure a failure on the part of the insured to notify the insurer of a claim made by a third party (a “demand”<sup>15</sup>). That is, the failure to notify is an omission to which s54(1) applies.<sup>16</sup>

Recently, the High Court in *FAI v AHC* extended s54(1) for the benefit of the insured in respect of a “claims made and occurrences notified” policy, however the High Court was clear in its view that the provision was not boundless.

At this juncture, it is necessary to examine the competing arguments, the state of the case law prior to *FAI v AHC* and the effect of the High Court’s latest pronouncement.

<sup>11</sup> M Burns, ‘FAI v Perry: High Noon in the High Court’ (2000) 12 *ILJ* 79 at 83.

<sup>12</sup> K Sutton, *Insurance Law in Australia* 3<sup>rd</sup> edn LBC Sydney 1999 at para 8.44 .

<sup>13</sup> [2001] HCA 38 (27 June 2001) at 23.

<sup>14</sup> M Burns; *supra* n 11 at 83.

<sup>15</sup> See majority decision in *FAI General Insurance v Australian Hospital Care* [2001] HCA 38 (27 June 2001) at para 40.

<sup>16</sup> *FAI v AHC*; see also *East End Real Estate Pty Ltd v CE Heath Casualty & General Insurance Ltd* (1991) 25 NSWLR 400 (Gleeson CJ, Mahoney, Clarke JJA).

#### 4. COMPETING VIEWS OF S 54(1) – THE TWO EVILS

Many argue that the results outlined above are beyond the intended object of s54(1).<sup>17</sup> However it is submitted that the reason for such a divergence of judicial (and academic) opinion<sup>18</sup> over the past decade between a wide or narrow construction, is that neither approach is entirely satisfactory.

A narrow reading of the term “omission” benefits insurers who can rely on a greater range of post-contractual failures on the part of insureds to refuse payment of a claim. However, many argue that it would be contrary to the remedial nature of s54(1) to read down the natural meaning of the term to the detriment of insureds.<sup>19</sup>

By contrast, a wide construction of “omission” would excuse a range of failures on the part of the insured, inadvertent or otherwise.

It was submitted in *FAI v Perry* with respect to a failure to notify of an occurrence under a “discovery” policy, that the insured may have sound reasons for not notifying the insurer of potential claims, including the effect it may have on future premiums. Gleeson CJ stated that it would be odd that such “a decision not to elect to expand the scope of cover”<sup>20</sup> could be classed as an omission.

Facing the dilemma in *FAI v AHC*, the High Court adopted a liberal interpretation of s54(1) – but not an interpretation without limit, balancing the competing views in line with the facts (but not the reasoning) in *Greentree* and *Permanent Trustee*.

#### 5. CHRONOLOGY OF CASES

##### 5.1 *East End Real Estate Pty Ltd v CE Health Casualty & General Insurance Ltd*<sup>21</sup> - (*East End*)

In *East End*, the insured sought to extend the operation of s54(1) to a “claims made and notified” policy.

In that case, a demand was made on the insured by a third party, however the insured failed to notify the insurer until some six weeks after the period of cover had expired. Under the terms of the policy, the insurer would have been entitled to deny liability based on the failure to notify.

The insurer argued that s54 did not apply to acts or omissions “which formed part of the definition of the risk insured”<sup>22</sup> and that it should not be used to widen the scope of the insured’s cover.

The NSW Court of Appeal held in favour of the insured, Gleeson CJ stating that the insurer’s argument must fail, as it would be a triumph of form over substance.

<sup>17</sup> *Supra* n 11 at 1.

<sup>18</sup> See Kirby J in *FAI v AHC* [2001] HCA 38 (27 June 2001) at para 63.

<sup>19</sup> *Antico* (1997) 188 CLR 652 at 675.

<sup>20</sup> (1993) 30 NSWLR 89 at 93.

<sup>21</sup> (1991) 25 NSWLR 400 (Gleeson CJ, Mahoney, Clarke JJA).

<sup>22</sup> K Sutton; *supra* n 12 at para 8.47].

It is important to note in that case that special leave to appeal to High Court was refused.

### 5.2 *FAI v Perry*<sup>23</sup>

Similarly to *FAI v AHC*, the facts before the NSW Court of Appeal in *FAI v Perry* concerned a “discovery” policy (occurrence notified policy).

The policy covered the insured, Perry for :-

- (a) claims made and notified during the currency of the policy; and
- (b) by virtue of clause 3, occurrences which may give rise to a claim outside the period of cover but which the insured became aware of and notified the insured during the period of cover. Upon notification, these subsequent claims were deemed by clause 3 to occur within the period of cover.

Perry argued that his failure to take advantage of clause 3 constituted an “omission” within s54(1).

The court held in favour of the insurer. Gleeson CJ and Clarke JA drew a distinction between an omission to act (to which s54(1) would apply) and a failure to exercise a right or election.<sup>24</sup>

### 5.3 *Kelly v New Zealand Insurance Co Ltd*<sup>25</sup> - (*Kelly*)

Applying *FAI v Perry*, the court in *Kelly* decided that a failure to increase the “insured value” of items under a home and contents policy by furnishing a list of the items’ values was not an omission to which s54(1) relates.

The court drew a distinction between “inaction” and an “omission”.<sup>26</sup>

### 5.4 *Antico*

In *Antico* the issue of an “omission” under s54(1) reached the High Court.

The case concerned a Directors’ and Officers’ legal expenses policy under which Antico was indemnified for legal expenses incurred in actions taken against him as a director during the period of cover. However, the indemnity was conditional upon the insurer consenting to defend the claim – consent that it was required to furnish if “reasonable grounds” for a defence existed.

Antico failed to obtain consent and argued, inter alia, that this failure could be excused under s54(1).

<sup>23</sup> (1993) 30 NSWLR 89 (Gleeson CJ, Clarke JA, Kirby P dissenting).

<sup>24</sup> *Ibid* at 93.

<sup>25</sup> (1996) 9 ANZ Ins Cas 61-317.

<sup>26</sup> *Ibid* at 76,518.

At first instance, Giles CJ Comm D relied on *FAI v Perry* in dismissing Antico's claim – applying the distinction between “inaction” / “non-event” and omission. Antico's appeal to the NSW Court of Appeal was dismissed.

In unanimously upholding the appeal, the High Court rejected the reasoning in *FAI v Perry* stating that “omission” did not merely refer to a failure to discharge an obligation owed by the insured, but included “a failure to exercise a right, choice or liberty which the insured enjoys under the contract of insurance”.<sup>27</sup>

The effect of *Antico*, according to Sutton, was :

...to spell the end of the distinction between inaction and omission to act, between failure to exercise a right of election and a failure to act, and of the attempt to limit the application of the subsection to the loss of a pre-existing right”.<sup>28</sup>

### 5.5 *Permanent Trustee* and *Greentree*

In *Greentree*, the insured seized upon the liberal interpretation handed down in *Antico* and attempted to extend the scope of s54(1) one step further. It was argued that the relevant “omission” was the failure on the part of the third party to make a demand (claim) on the insured within the period of cover.

The NSW Court of Appeal rejected *Greentree*'s submissions. Mason P adopted the distinction between an “act” and a “non-event” as outlined by Gleeson CJ in *East End*<sup>29</sup>. Spigelman CJ described the failure on the part of a third party to make a demand as “an event wholly external to the policy”.<sup>30</sup>

On the same point in *Permanent Trustee*, Hodgson CJ in Eq stated that “the gravamen of the refusal [by the insurer to meet a later claim on it] is not that someone omitted to do something, but rather that something did not happen”.<sup>31</sup>

Whilst the result in *Greentree* seemed to be a correct one, it remained difficult to reconcile the reasoning of the Court of Appeal with the liberal approach taken by the High Court in *Antico*. Though factually distinguishable from *Antico*, the reasoning in *Greentree* was questionable given the approach laid down by the High Court<sup>32</sup> and in any event, remained short-lived.

## 6. *FAI v AUSTRALIAN HOSPITAL CARE*

In the face of the uncertainty following *Greentree* and *Permanent Trustee*, the High Court seized the opportunity to resolve the confusion in *FAI v AHC*.

<sup>27</sup> (1997) 188 CLR 652 at 669, 670.

<sup>28</sup> *Supra* n 12 at para 8.72.

<sup>29</sup> (1991) 25 NSWLR 400 at 405.

<sup>30</sup> (1998) 158 ALR 592 at 595.

<sup>31</sup> (1998) 44 NSWLR 706 at 710 as quoted in *FAI v AHC* [2001] HCA 38 (27 June 2001) at para 38.

<sup>32</sup> A Christopher, ‘The Latest Word on *FAI v Perry: Greentree v FAI General Insurance Co Limited*’ (1999) 10 *ILJ* 189 at 4-5.

The facts before the court were that the insured (AHC) was covered by a policy of professional indemnity insurance with FAI from 20 June 1992 to 20 June 1993. In circumstances substantially identical to those in *FAI v Perry*, condition three (3) of the contract “deemed” claims to have been made within the policy period, if the insured notified the insurer within that period of circumstances giving rise to a subsequent claim.

Despite being aware of an injury occurring prior to the FAI cover, AHC failed to notify the insurer and take advantage of condition 3 as it was “not expected...that a claim would be made”.<sup>33</sup> The insured argued that this was an omission that could be cured by s54(1).

At first instance, the court found for the insured. A majority in the Queensland Court of Appeal dismissed FAI’s appeal.<sup>34</sup>

On appeal to the High Court, a 4:1 majority<sup>35</sup> found in favour of the insured.

*McHugh, Gummow, Hayne JJ*

McHugh, Gummow and Hayne JJ criticised the reasoning in *Greentree* and *Permanent Trustee* although “the actual decision in each was right”.<sup>36</sup> Instead their Honours offered an alternative explanation. They stated that s54(1) “does not operate to relieve the insured of restrictions or limitations that are *inherent in the claim*”.<sup>37</sup>

It is submitted that their Honours have proffered a distinction between an inherently essential element of a claim as a matter of law (to which s54(1) cannot apply) and other merely ancillary or procedural matters.

Adopting the High Court’s examples :

(a) “Occurrence” policies

The “occurrence” is the essential element – therefore s54(1) will not operate to cure a failure of the event to occur giving rise to liability under the policy.

(b) “Claims made” or “claims made and notified” policies

The fact of the “demand” being made by the third party *within* the policy period is the essential element – therefore, s54(1) will not cure the failure of a third party to make the demand (as per the facts in *Greentree*).<sup>38</sup>

(c) “Discovery” policies

<sup>33</sup> [2001] HCA 38 (27 June 2001) at para 4.

<sup>34</sup> *FAI General Insurance Co Ltd v Australian Hospital Care Pty Ltd* (1999) 10 ANZ Ins Cas ¶61-445 (Derrington and Chesterman JJ; Pincus JA dissenting).

<sup>35</sup> *McHugh, Gummow, Kirby and Hayne JJ, Gleeson CJ dissenting.*

<sup>36</sup> [2001] HCA 38 (27 June 2001) at para 39.

<sup>37</sup> *Ibid* at para 41 {*emphasis added*}.

<sup>38</sup> *Ibid* at para 42.

The inherent limitation is the fact of the insured becoming aware of facts giving rise to a subsequent claim – therefore a *failure to become aware* cannot be cured by s54(1).<sup>39</sup>

### *Kirby J*

Also in the majority, Kirby J rejected the previous attempts to apply artificial distinctions to the term “omission”<sup>40</sup> but rather applied a test based on causation.<sup>41</sup> His Honour’s approach is to look to the “real reason” for the insurer’s refusal to pay<sup>42</sup> – to determine as a matter of law whether that refusal was “by reason of” an omission of the insured or some other person (to which s54(1) would apply), or “by reason of” the fact that the claim does not fall within the policy.

Applying this reasoning to *Greentree*, McHugh, Gummow and Hayne JJ stated that :

...the reason for the refusal was *not* some act or omission of the insured or some other person. It was that the policy did not extend to the demand referred to in the claim for indemnity [because it was made out of time].<sup>43</sup>

### *Gleeson CJ*

In dissent, Gleeson CJ also focuses on the cause of the insurer’s refusal as the relevant test. His Honour held that the real reason for FAI’s refusal was that a demand was not made on the insured during the policy period, not a failure on the part of the insured to take advantage of condition 3.<sup>44</sup> However, with the greatest of respect to the Chief Justice, this approach seems to turn on matters of form and might for instance, be different if condition 3 were not expressed as an optional extension, but as part of the scope of cover itself.<sup>45</sup>

## 7. CONCLUSION

In strict terms, *FAI v AHC* had no real effect on the operation of s54(1) on “claims made and notified” policies – that position being set down in *East End* (and accepted in *Antico*) and with the court accepting the decision (but not the reasoning) in *Greentree*. *FAI v AHC* dealt with a situation which was one step further removed from a mere failure to notify of a claim, that is, a failure to elect to extend the scope of cover to possible future claims. With the exception of the Chief Justice, the High Court was willing to extend the operation of s54(1).

In terms of settling the debate, the importance of the decision was to clearly and unambiguously declare *FAI v Perry* as no longer good law, to extend s54(1) to a failure to notify under a “discovery” policy, but importantly – to clearly set out the limits of s54(1), which McHugh, Gummow and Hayne JJ accomplished through their “restrictions inherent in the claim” test.

<sup>39</sup> *Ibid* at para 43.

<sup>40</sup> *Ibid* see para 79, 80, 81.

<sup>41</sup> *Ibid* at para 82.

<sup>42</sup> *Ibid* at para 84, 85.

<sup>43</sup> *Ibid* at para 44.

<sup>44</sup> *Ibid* at para 9.

<sup>45</sup> See the wide definition of “Claim” in the policy at issue in *East End*.

However, with the High Court drawing fine distinctions (especially Kirby J on the issue of causation) and with the result, in the opinion of the Chief Justice, beyond what was intended by parliament,<sup>46</sup> legislative intervention to limit *FAI v AHC* may be a foreseeable consequence.

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<sup>46</sup> [2001] HCA 38 (27 June 2001) at para 12.