The characterisation and protection of lenders' interests in insurance

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There are numerous circumstances in which lenders can come to have an interest in insurance policies maintained primarily by borrowers. This article examines the position of lenders in relation to such insurance policies, both where the lender is covered by the policy (as an insured or as a third party beneficiary) and where it is not (such as where the lender is merely a loss payee or an assignee). Where insurance covers multiple persons (such as where a borrower maintains insurance which extends to the benefit of a lender), difficult issues can arise as to the relative positions of the parties in the event that the conduct of one jeopardises a claim or the existence of the policy itself. The underlying object of this article is to raise awareness about those issues. This object is manifest in the two stated purposes of this article, being to provide a critical introduction to the ways in which a lender may become interested in an insurance policy, and to suggest contractual means by which such interests may be protected.

1 INTRODUCTION

Lenders invariably have some interest, whether insurable or merely commercial, in potential losses and liabilities to which borrowers and/or secured assets are exposed. Such interests arise throughout the full range of credit supply scenarios. Most obviously, lenders will have an interest in the physical integrity and value of tangible property which secures debts, such as under standard fixed security loans like home loans and business equipment loans, as well as in relation to lines of credit secured by floating charges over stock in trade. Lenders will also have an interest in a broader range of potential losses or liabilities which might affect a project which is project financed (ie where the proceeds of the project service the debt). Protecting these interests is not only appropriate for the lender in maintaining the value of its security interests and managing its general counterparty risk, but also can assist lenders in laying portfolios of receivables off to capital markets by way of securitisation.[1]

Where the lender's interest is insurable, it would be open to it to seek insurance cover in its own name. Inevitably, this will involve costs for the lender in the form of premiums as well as the administrative burden of applying for insurance and complying with the statutory duty of disclosure. Alternatively, lenders with sufficient scale might wish to self-insure or insure through a captive.[2] Both of these options involve significant capital commitments and, in the case of captive programs, insurance premiums, given that the risk is ultimately laid off to reinsurers. In any event, most borrowers have insurance against physical risks to tangible property the subject of finance, or would

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[1] Lenders who provide for appropriate controls over the insurance of security assets are significantly better placed in the event of securitisation than those which do not. The perception of credit risk in the portfolio, and accordingly its attractiveness to credit-rating agencies and subscribers, will usually be impacted by the adequacy of insurances.

[2] Broadly, a captive insurer is one who insures only its related bodies corporate.

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likely be prepared to accede to a requirement to arrange such cover. This opens up an attractive option for lenders in relation to the risk of financed property being damaged or destroyed – have the borrower's insurance extend to cover the lender's interests.

Generally, this involves the lender being a third party beneficiary in relation to the borrower's insurance (ie not a contracting insured). Status as a third party beneficiary can allow the lender to bring a claim in its own name in respect of its own losses and, subject to important qualifications, apply the policy proceeds as it sees fit (such as to the reduction of debt).

Whilst, as a matter of common experience, it seems that lenders will normally be third party beneficiaries to their borrowers' insurances, there are circumstances in which lenders will be contracting insureds. This is borne out by the number of reported cases (some of which are discussed below) in which it appears to have been accepted that the lender was a contracting insured alongside the borrower. Also, the treatment at general law of the relative positions of multiple contracting insureds has heavily influenced the treatment of third party beneficiaries, which makes it appropriate to examine the position of the former even if it does not represent the position lenders are most likely to occupy in the ordinary course.

Against this background, the present article has two purposes. First, it seeks to introduce lenders (or, more probably, their legal advisers) to the range of positions financiers (and their borrowers) may occupy in relation to a policy of insurance. As noted, there is a number of ways in which a person may become interested in a policy of insurance. Amongst these, this article analyses (in Part 2) the situations in which a person is: a contracting insured; a non-contracting (ie third party) beneficiary; an assignee; or a loss payee. Within the framework of these categories, Part 2 also discusses the circumstances in which a person's interest in an insurance policy can be jeopardised, even destroyed, by the misdeeds of another interested person.

The second of this article's purposes is to identify ways in which insurance obligations in finance documents can be drafted so as to secure the lender's interests, whether insurable or commercial, in insurance coverage. This is contained in Part 3, which also contains brief descriptions of a range of insurance policies of relevance to lenders in this context.

2 WHERE THE LENDER IS INTERESTED IN INSURANCE

Insurance policies are often expressed to cover multiple persons as insureds or as interested parties. Typically, a distinction is drawn in the language of insurance documents between "named insureds" and "noted [or interested] parties". It appears that the former is intended to refer to contracting insureds and the later to non-contracting (ie third party) beneficiaries. However a person may be described in a policy document, their status in relation to a contract of insurance is ultimately a question of fact and general law. Thus, describing a person as a "named insured" or listing them in a policy schedule under the heading "insured" does not make them a party to the contract of insurance. Equally, treating a party on the face of the policy as someone whose interests are merely "noted" could not in itself deprive them of privity.

In these circumstances, care needs to be taken in characterising a person's interest in a contract of insurance. Before discussing the relative positions of parties and non-parties who are entitled to the benefit of a contract of insurance, it is first necessary to draw a more fundamental distinction between persons who are interested in a contract of insurance in the sense of being covered by the insurance in respect of their own losses and/or liabilities, and persons who are interested in the significantly more restricted sense of being entitled to receive or recover policy proceeds in respect of another's losses and/or liabilities.[3] In the latter case, the person's interest is narrow and, it may be said, largely administrative in nature. Into this category fall assignees and loss payees (whose respective positions are discussed briefly at the end of this Part). In the former category are persons actually covered by

[3] Taking a broad view of "interests", there is perhaps a further category of interested party to be noted, being parties who have an interest in another party being insured but have no rights whatsoever in relation to the insurance or the policy proceeds. Lenders will be in this situation where they desire that certain insurances are effected and maintained by borrowers without requiring that cover to be extended to the lender and without having any rights over claims or policy proceeds.

the insurance either as contracting insureds or as third party beneficiaries. Interests of this sort are the primary focus of this Part, and of this article. They are discussed below.

Multiple contracting insureds: Joint and composite insurance

Where multiple persons are, as a matter of fact, parties to a contract of insurance (as distinct from third party beneficiaries, who are discussed below), the insurance may be either joint or composite. The notions of joint insurance and composite[4] insurance are essentially different ways of conceptualising the relationship between, or relative positions of, different persons covered under a single contract of insurance.[5]

The characterisation of a policy as providing joint or composite insurance ultimately rests on the proper construction of the coverage provided by the policy. In construing the policy, it is relevant to consider the nature of the interests of the insureds. Indeed, the nature of the insureds' interests is arguably determinative, though this is a point of some controversy.[6] Under a joint policy of insurance, the interests of the insureds in the subject matter of the insurance are intertwined and regarded as inseparable (eg joint ownership of property under a property policy). Under a composite policy of insurance, by contrast, the insureds have distinct interests which are, in effect, separately insured under the one contract of insurance.

There have been a number of reported cases in which insurance over property owned jointly has been regarded as composite in nature. The Supreme Court of Tasmania held in one case that policies covering various items of property owned jointly and individually was, on its proper construction, composite in nature.[7] In a subsequent judgment of the High Court of New Zealand, Eichelbaum CJ seemed to adopt this approach in favouring "the modern rule in concentrating on the interpretation of the contract of insurance, rather than on the nature of the interest of the insured in the insured property".[8] Whilst doubts may be (and have been)[9] expressed about the basis for these decisions,[10] it is at least prudent to analyse the terms by which coverage is defined in the policy,[11] rather than directly following the nature of the interests covered, in determining whether the insurance is joint or

[4] Composite insurance is sometimes abbreviated to "co-insurance". That abbreviation has not been used here so as to avoid confusion with an entirely separate notion also referred to as co-insurance, being the situation in which multiple persons have co-ordinate liabilities in relation to a single contingency. In that situation, the co-insurers (one of which may be an insured under the relevant policy) contribute to their common liability in specified proportions. Generally, one co-insurer may discharge the obligations of all co-insurers and recover from that other (or those others) the amount of its (or their) liability.

[5] As Sutton notes, composite and joint insurance, under which the coverage of multiple parties derives from a single contract of insurance, must be distinguished from the situation in which distinct contracts of insurance are evidenced by a single policy document. In the latter case, each contract of insurance operates separately (unless there is some term to the contrary) notwithstanding the common documentation: Sutton K, *Insurance Law in Australia* (3rd ed, LBC Information Services, 1999) p 302. That a joint policy is a single contract is plain. In support of the notion that a composite policy is a single contract, reference may be made to *Deaves v CML Fire & General Insurance Co Ltd* (1979) 143 CLR 24 at 41; 53 ALJR 382; 23 ALR 539; 1 ANZ Ins Cas 60-011, per Gibbs CJ.

[6] The relevance of the nature of the insureds' interests to the characterisation of the insurance was emphasised in *Lombard Australia Ltd v NRMA Insurance Ltd* [1968] 3 NSWR 346 at 347 per Wallace A-CJ and at 350-351 per Holmes JA (with whom Walsh JA agreed); 72 SR (NSW) 45; 89 WN (Pt 2) (NSW) 70; [1969] 1 Lloyd's Rep 575.

[7] *Holmes v G R E Insurance Ltd* [1988] Tas R 147 at 150; (1988) 5 ANZ Ins Cas 60-894, per Neasey J.

[8] *Maulder v National Insurance Co of New Zealand Ltd* [1993] 2 NZLR 351 at 358; (1992) 7 ANZ Ins Cas 61-141.

[9] Rodd, C J, "Fraudulent Claims and the Rights of the Innocent Co-insured" (1997) 9 Insurance LJ 38 particularly points to the lack of analysis in these cases of exclusions potentially placing the loss outside the scope of cover.

[10] Both cases concerned the deliberate destruction by one insured of property which was, at least in part, jointly owned by the insureds. In both cases, the courts found that the insurance was composite in nature and that the innocent insured's claim was not prejudiced by the disentitling conduct of the other. It is tempting to say in respect of both cases that the courts sought to relieve the plaintiffs of the harsh consequences of characterising the insurance as joint (being that the disentitling conduct of one insured would prevent the other from recovering) and so treated it as composite, proffering the construction of the cover as the basis given the findings as to the nature of the proprietary interests.

[11] Additionally, if the insureds are listed (typically in the policy schedule) as covered "for the respective rights and interests", this would tend to suggest that the insurance is intended to be composite, though this phrase is neither necessary nor sufficient in characterising a policy as one of composite insurance.

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composite.[12] That said, the better view in circumstances where there are separate and distinct interests in insured property (such as where the insureds are a mortgagee and mortgagor of the insured property) seems to be that the insurance will necessarily be composite.[13] Thus, in the ordinary course, lenders are likely to have separate and distinct interests from borrowers in property securing a debt, such as to make any insurance to which both are party composite.

The distinction between joint and composite insurance is not a matter of academic interest alone. It can determine an insured's ability to recover where there has been disentitling conduct by another insured. This is particularly pertinent for lenders who are contracting insureds alongside borrowers, as lenders will often be uninvolved in disentitling conduct, but would nevertheless have an expectation that insurance recoveries will be available in the event of loss or damage. Before canvassing this issue, it is important to note the distinction between conduct which affects the insured's ability to recover in respect of a claim (eg a breach of a policy condition)[14] and conduct which can lead to the invalidation of the insurance contract (eg a fraudulent breach of the duty of disclosure).[15]

Joint and composite insurance both posit the existence of a single contract of insurance. Accordingly, if the insurer exercises its right to regard the contract as void from inception (ie in the event of a fraudulent breach of the duty of disclosure) or cancels it prospectively (such as in the event of a non-fraudulent non-disclosure or misrepresentation),[16] the fundamental basis for the rights of all insureds under the policy, being the contract, will be absent. Thus, conduct affecting the very

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[12] It may be noted that, in *Australian Guarantee Corporation Ltd v Western Underwriters Insurance Ltd* [1988] 2 Qd R 119, Macrossan J was strongly influenced by the distinct nature of the insureds' interests in finding that it had not been established that the policy was joint. His Honour nevertheless seemed to be open to the notion that the insureds' interests would not determine the nature of the insurance when he said (at 124) that "if the interests in the property are distinct ... then the policy may well not be joint but composite". Significantly, his Honour did not say that in such a case the policy *will* be composite, rather, it *may well* be.

[13] The views of Macrossan J (described in the preceding footnote) may be contrasted with the obiter dicta of Gaudron J in *Federation Insurance Ltd v Wasson* (1987) 163 CLR 303 at 318; 61 ALJR 440; 72 ALR 567; 5 MVR 289; 4 ANZ Ins Cas 60-794 that "an obligation to indemnify two or more persons against loss or damage to property in which they hold separate interests, even if expressed to be owed to them jointly is necessarily owed to them severally". Before reaching this conclusion, her Honour stated that the nature of the insurance is determined on the proper construction of the policy, but in the case of ambiguity is determined by the nature of the interests of the insureds. This latter proposition is said to follow the rule in *Slingsby's case* (1587) 77 ER 77. The suggestion that separate interests cannot be covered under a joint policy of insurance subsequently found support in the judgment of Tadgell J in *V L Credits Pty Ltd v Switzerland General Insurance Co Ltd* [1990] VR 938 at 944-945; (1989) 5 ANZ Ins Cas 60-936.

[14] Not all breaches of policy conditions affect the insured's rights under the policy. For instance, s 54 of the *Insurance Contracts Act 1984* (Cth) is generally available to relieve an insured of the effects of failing to notify a claim (or of a circumstance which may give rise to a claim, pursuant to a contractual deeming clause) under so-called "claims made and notified" policies. For a summary of the operation of s 54, see Scott T J, "Casenote: *FAI General Insurance Co Ltd v Australian Hospital Care Pty Ltd*" (2001) 12(3) Insurance LJ 271. It should be noted that an exposure draft for proposed amendments to s 54 has been released: Exposure Draft, *Insurance Contracts Amendment Bill 2004* (Cth), 8 March 2004. The purpose of the proposed amendments is to prevent s 54 from providing relief in relation to a failure to provide notification of circumstances pursuant to a contractual deeming provision.

[15] Sections 28 and 60 of the *Insurance Contracts Act 1984* (Cth) set out the insurer's remedies where a person fails to comply with the duty of disclosure or makes a misrepresentation to the insurer before the contract of insurance is entered into. If the non-disclosure or misrepresentation was fraudulent, the insurer may, under subs 28(2), avoid the contract (which, according to the definition of "avoid" in subs 11(1), means from inception). If the non-disclosure or misrepresentation is not fraudulent (or is, but the insurer declines to avoid the policy), the liability of the insurer in respect of a claim is reduced, pursuant to subs 28(3), by an amount which places the insurer in the position it would have been in had the non-disclosure or misrepresentation not been made. Whilst there are different ways of conceptualising the basis for a reduction in liability under subs 28(3), it is now well established that an insurer's liability can be reduced to nil under that subsection. Importantly, the remedies under s 28 apply only where the insurer would not have entered into the contract of insurance for the same premium and on the same terms and conditions had the non-disclosure or misrepresentation not been made. If there is a non-disclosure or misrepresentation not resulting in the avoidance of the policy (usually, because it is not fraudulent), the insurer may cancel the policy prospectively under s 60.

[16] Any claim which arises prior to a prospective cancellation where that cancellation is based on a (non-fraudulent) non-disclosure or misrepresentation will fall to be determined in accordance with s 28 of the *Insurance Contracts Act 1984* (Cth). As discussed below, it appears that, if the insurer is able to reduce its liability to nil in relation to a claim (pursuant to subs 28(3)), the insurer can avoid liabilities against "innocent" insureds under a composite policy (see n 27) and third party beneficiaries (see n 36), to the same extent.

existence of the policy will affect all insureds equally under both joint and composite policies.[17] Conduct which merely affects rights in relation to claims, however, is significantly more complex.

In the case of joint insurance, it follows from the commonality of the insureds' interests in the subject matter of the insurance that conduct which affects one insured's ability to recover in respect of a given claim will affect all insureds equally.[18] Thus, where an insured breaches a policy condition or otherwise engages in disentitling conduct in relation to a claim, the other (innocent) insured will not be able to maintain an independent claim in relation to the same subject matter. An example might be where a husband and wife jointly insure property (such as a house) which is jointly owned by them, and one of them deliberately destroys the property.[19] In that case, the other insured, who may have no involvement whatsoever in the disentitling conduct, is placed in the same position as their partner vis-à-vis the insurance covering the property, which is to say that neither can recover if one cannot.

Since composite insurance is characterised by the protection of distinct interests, there is less warrant for treating the misdeeds of one insured as the misdeeds of all (as in joint insurance). Rather, proceeding from first principles, it would seem that the disentitling conduct of one insured ought only to prejudice that insured's own claim. The weight of the common law in this area favours this position. The position, as developed over the course of four seminal cases, is summarised below.

Sir Wilfrid Greene MR[20] pioneered, or was at least the first clearly to articulate, the modern distinction between joint and composite insurances in the first of these four seminal cases, *General Accident Fire and Life Assurance Corporation Ltd v Midland Bank Ltd* [1940] 2 KB 388; 3 All ER 252; 67 Ll L Rep 218.[21] In that case, the distinctions between the interests of the various insured parties (including a lender) led the Master of the Rolls to find that the insurance was composite in nature, covering the separate interest of each party in the subject matter of the insurance "for their respective rights and interests". From there, his Lordship proceeded on the basis that the policy was to be applied distributively in respect of each insured and seemed to say in obiter dicta that the disentitling conduct of one insured would not have affected the other insureds.[22]

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[17] Sutton, n 5, p 310–311 notes that in this regard "the distinction drawn at common law between joint and composite contracts of insurance has been obliterated". In this connection, Sutton cites *Zurich Australian Insurance Ltd v Contour Mobel Pty Ltd* [1991] 2 VR 146 at 151–152; (1990) 6 ANZ Ins Cas 60-984, per Gobbo J.

[18] See Sutton, n 5, p 302–303 and the authority cited there. It is worth bearing in mind that joint insurance essentially assumes a commonality of interests such that the insureds are treated as one under the policy. The suggestion that joint insureds could stand in different positions in relation to a claim tends, by analogy, to undermine the principle upon which is based the axiomatic principle that an insurer cannot bring a subrogated claim against an insured which, in relation to the same subject matter, it has indemnified.

[19] This factual situation is not as fantastic as one might hope and believe. There are at least five reported insurance cases in Australia and New Zealand in which a husband (in one case, a wife) has destroyed the jointly owned matrimonial home by fire: *Holmes v G R E Insurance Ltd* [1988] Tas R 147; (1988) 5 ANZ Ins Cas 60-894, *Maulder v National Insurance Co of New Zealand Ltd* [1993] 2 NZLR 351; (1992) 7 ANZ Ins Cas 61-141, *RG Winstanley & E Winstanley v Allianz Insurance Co Ltd* (1984) 3 ANZ Ins Cas 60-567, *Clayton v Mutual Community General Insurance Pty Ltd* (1995) 64 SASR 353; 182 LSJS 77; 8 ANZ Ins Cas 61-263, and below. In the first two cases, the wife was able to recover in respect of her interest in joint property on the basis that the insurance cover was composite in nature. The relevance of these cases here is that it appears to have been accepted that, if the insurance was joint, the innocent insured's claim would necessarily have failed. In the latter two cases, the judgments do not address the nature of the coverage (ie joint or composite) and are therefore relatively inconsequential for present purposes. *McQuade v Sun Alliance Insurance Co* (1992) 7 ANZ Ins Cas 61-136 concerned the destruction of a jointly owned home by the wife. The New Zealand High Court held that the husband was prevented from recovering on the basis that the property insurance was joint in nature and that recovery in respect of joint rights can be had only where all the joint parties are in a position to sue on those rights. Since the wife's conduct had prevented her from enforcing the policy, the husband's claim was jointly disentitled.

[20] With whose speech Scott and Goddard LJJ agreed.

[21] His Lordship's formulation must now be regarded as the classic statement of the law in this area. In the key passage, he states that in composite insurance "the interest of each of the insured is different. The amount of his loss, if the subject-matter of the insurance is destroyed or damaged, depends upon the nature of his interest, and the covenant of indemnity which the policy gives must, in such a case, necessarily operate as a covenant to indemnify in respect of each individual different loss which the various persons named may suffer. There is no joint element at all in such a case": *General Accident Fire and Life Assurance Corporation Ltd v Midland Bank Ltd* [1940] 2 KB 388 at 404; 3 All ER 252; 67 Ll L Rep 218.

[22] *General Accident, Fire and Life Assurance Corporation Ltd v Midland Bank Ltd* [1940] 2 KB 388 at 408; 3 All ER 252; 67 Ll L Rep 218.

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The position in Australia was further developed by the NSW Court of Appeal in *Lombard Australia Ltd v NRMA Insurance Ltd* [1968] 3 NSWR 346; 72 SR (NSW) 45; 89 WN (Pt 2) (NSW) 70; [1969] 1 Lloyd's Rep 575. In that case, a financier and a hire purchaser of a motor vehicle entered into a policy of insurance covering the motor vehicle against accidental loss and damage. The hire purchaser deliberately damaged the vehicle in the course of committing suicide. One of the questions ultimately before the court was whether or not the damage was "accidental", as required by the policy. After determining that the policy was one of composite (rather than joint) insurance, the court found that the "several" nature of the promise to indemnify meant that the nature of the damage was to be determined from the perspective of the present claimant (ie the financier). Since the damage was accidental qua that party, its claim was not precluded on the basis that the damage was deliberately caused by another insured.

The third significant case in this line, *Federation Insurance Ltd v Wasson* (1987) 163 CLR 303; 61 ALJR 440; 72 ALR 567; 5 MVR 289; 4 ANZ Ins Cas 60-794, concerned the cancellation of a composite policy of insurance by (or on behalf of) one insured, being the Wasson family,[23] shortly before an incident in which the subject-matter of the insurance, a leased motor vehicle, was damaged beyond repair. The lessor/financier of the motor vehicle was also insured under the policy and the question ultimately on appeal before the High Court was whether or not the Wassons could unilaterally terminate the policy (ie without the lessor/financier's participation). It was held that the clause in the contract allowing for termination by "the insured" referred to the cancellation of the policy as a whole, not to an insured's separate interest in the policy. Accordingly, unilateral cancellation was not possible and the policy therefore remained on foot at the time of the incident.

Two years after the High Court decided *Wasson's* case, Tadgell J in the Supreme Court of Victoria handed down his much analysed judgment in *V L Credits Pty Ltd v Switzerland General Insurance Co Ltd* [1990] VR 938; (1989) 5 ANZ Ins Cas 60-936. That case involved the destruction of the insured premises by a fire, which was taken for the purposes of the hearing to have been deliberately lit by the insured lessee of the premises. The insurance also covered a mortgagee of the lessee, whose rights under the policy were subsequently assigned to the plaintiff (who was also "noted" on the policy). The plaintiff's claim was put on the alternative bases that it was a contracting insured and that it was a third party beneficiary under s 48 of the *Insurance Contracts Act 1984* (Cth) (ICA). Tadgell J set out eight principles relevant to whether or not the insurance was composite and the effect of such a characterisation.[24]

Of these principles, two are of particular relevance here. The sixth principle espoused is that, where there is a composite policy covering the separate interests of distinct insureds, "a claim for indemnity in respect of loss or damage to one of those separate and individual interests is to be made and determined independently of a claim for indemnity, if there is one, in respect of loss or damage to the other".[25] The other principle of immediate relevance is the seventh (the substance of which is also reflected in the eighth principle), which is that insureds under a composite policy may undertake joint or joint and several obligations to an insurer. This is significant because it raises the possibility that the breach of a condition of a policy by an insured under a composite policy might disentitle all insureds if that condition was upon the insureds jointly. The nature of any given obligation will be determined as a matter of construction. A common problem which arises in this connection is that pro forma policies often place obligations on "the insured", which must be construed either distributively or collectively.

Whilst, as a matter of common law, the disentitling conduct of an insured under a composite policy is unlikely to be able to be relied upon to defeat a claim by an innocent insured, it should be noted that the insurer's statutory rights (under the ICA) to reduce its liability in certain circumstances

[23] In their joint judgment, Mason CJ, Wilson, Dawson and Toohey JJ noted in passing that "[t]he Wassons, of course, as between themselves, have a joint interest and the insurance they gained under the policy was a joint insurance. But their interest in the vehicle was quite distinct from that of [the lessor]": *Federation Insurance Ltd v Wasson* (1987) 163 CLR 303 at 309; 61 ALJR 440; 72 ALR 567; 5 MVR 289; 4 ANZ Ins Cas 60-794.

[24] *V L Credits Pty Ltd v Switzerland General Insurance Co Ltd* [1990] VR 938 at 944–945; (1989) 5 ANZ Ins Cas 60-936.

[25] *V L Credits Pty Ltd v Switzerland General Insurance Co Ltd* [1990] VR 938 at 945; (1989) 5 ANZ Ins Cas 60-936.

may be available in relation to a claim by an innocent insured under a composite policy.[26] As noted above,[27] s 28 of the ICA allows an insurer, in the event of a non-disclosure or misrepresentation not resulting in the avoidance of the policy (usually, where the non-disclosure or misrepresentation is not fraudulent), to reduce its liability "in respect of a claim" to such amount as would place it in the position it would have been in had the non-disclosure or misrepresentation not been made. Effectively, this reduction amounts to the set-off of damages against an insurance payout, and may result in a claim being reduced to nil. The reference to "a claim" raises a difficult point of construction: it might be a reference to a claim of the particular insured who committed the non-disclosure or misrepresentation; or it might refer to any claim under the policy. If the latter construction is correct (which seems to be the case, at least where the insurer's liability can be reduced to nil),[28] a reduction applicable under s 28 in the event of a non-disclosure or misrepresentation by an insured will be able to be applied to the claim of an innocent insured under a composite policy.

Overall, the position of insureds under joint and composite policies is as follows:

	TYPE OF CONDUCT	
TYPE OF POLICY	**Conduct affecting the policy**[29]	**Conduct affecting a claim**[30]
Joint	*affects all insureds equally*	*affects all insureds equally*
Composite	*affects all insureds equally*	*affects "guilty" insured only, unless a joint obligation is involved or there is a non-disclosure or misrepresentation*

It should be noted that there is no general principle that an insurer cannot be subrogated to the rights of one insured against another. There are some circumstances in which it is clear that an insurer cannot, by subrogated action, recover against a person insured by that insurer. This is where the subrogated action goes to the heart of the insurer's indemnification of that insured. For instance, if an insurer insurers the joint owners of a motor vehicle under a comprehensive policy and, through a negligent omission of one person which is not disentitling, the vehicle is lost, the insurer cannot provide indemnification against the loss and then be subrogated to the innocent insured's rights against the other in negligence. It is clear in that case that the insurer cannot effectively reverse its

[26] Sections 28 and 54 of the *Insurance Contracts Act 1984* (Cth) both provide for a reduction of an insurer's liability in different circumstances.

[27] See n 15.

[28] In *Zurich Australian Insurance Ltd v Contour Mobel Pty Ltd* [1991] 2 VR 146; (1990) 6 ANZ Ins Cas 60-984, Gobbo J held that subs 28(3) of the *Insurance Contracts Act 1984* (Cth) can apply to reduce the insurer's liability to all insureds under a policy to nil, regardless of whether the insurance is joint or composite. This was apparently an extension of the High Court's judgment in *Advance (NSW) Insurance Agencies Pty Ltd v Matthews* (1989) 166 CLR 606; 63 ALJR 365; 85 ALR 161; 5 ANZ Ins Cas 60-910 where, in a joint judgment, Mason CJ, Dawson, Toohey and Gaudron JJ held that, the statutory duty of disclosure (in s 21) applied to each insured and that a fraudulent failure of an insured to comply with that duty entitled the insurer to avoid the entire contract of insurance pursuant to subs 28(2), regardless of whether the insurance was joint or composite. This issue is also touched on in Nicholson K, "Conundrums for Co-Insureds Part I" (1990) 3 Insurance LJ 218 at 236–237.

[29] This is conduct affecting the existence of the policy either from inception (a fraudulent breach of the duty of disclosure or a fraudulent misrepresentation inducing the contract), or prospectively (conduct entitling the insurer to cancel the policy, such as a non-fraudulent breach of the duty of disclosure or misrepresentation).

[30] This is conduct affecting an insured's claim, such as a failure to comply with a policy condition not able to be relieved under s 54 of the *Insurance Contracts Act 1984* (Cth), or a non-disclosure or misrepresentation entitling the insurer to reduce its liability under subs 28(3). Conduct which is imputable to the "innocent" party is not covered here, such as where the "guilty" insured is, in reality, the "innocent" insured's agent. This situation was referred to by Macrossan J in *Australian Guarantee Corporation Ltd v Western Underwriters Insurance Ltd* [1988] 2 Qd R 119 at 124.

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indemnification on the policy terms through subrogated actions amongst insureds. It must be acknowledged, however, that there is apparently some scope for debate in this connection.

It has been suggested that, where an insurer provides indemnification in respect of a first-party loss, then seeks to recover against a person covered by the policy by way of subrogated action, there is no conceptual difficulty since the subrogated action would yield a liability for the person claimed against, rather than a first-party loss (in respect of which indemnity is provided).[31] This argument is aided by the obscurity of the foundations upon which the proposition described in the preceding paragraph is built. Typically, circuity of action is pointed to as the reason that an insurer cannot be subrogated to the rights of an insured against another insured where the relevant indemnity is in respect of a loss rather than a liability. It has been suggested that there is no circuity of action since the subrogated action would yield a liability rather than a loss and is therefore not indemnifiable by the insurer under the obligation giving rise to the primary indemnity.

Whatever the reasons, the fundamental point remains that, whilst an insurer cannot in some cases be subrogated to an insured's rights against another insured, there are circumstances in which it can. The relevance to lenders as insureds is that any liabilities they have to borrowers are not necessarily extinguished by the existence of a common insurance policy. Additionally, where lenders are reliant on a borrower's right to recover insurance proceeds, the borrower's exposure to subrogated claims by its fellow insureds should be considered.

Third party beneficiaries

The starting point in any discussion of the rights third parties may have under other people's insurance is to note that insurance policies are at base creatures of contract law and, subject to statutory modification (principally by the ICA), are to be construed in accordance with general law principles. Of relevance in this connection are the fundamental contractual notions of consideration and privity. Basically, the lack of consideration flowing from third parties and their concomitant lack of privity to the promise to indemnify create barriers at common law to the enforcement of insurance contracts by third parties. Additionally, the general law relating to insurance throws up a further barrier before third parties, being the doctrine of indemnity under which a person cannot recover other than for the person's own actual losses (or liabilities).

It is often suggested that as a practical matter insurers generally recognised the claims of third parties identified in policies as being entitled to cover, despite the lack of a clear legal basis for such claims. Shortly before the commencement of the ICA (specifically, s 48, which is discussed below) Trident General Insurance Co Ltd broke with this practice and denied indemnity to such a third party, McNiece Bros Pty Ltd, in relation to a liability claim. The matter ultimately came before the High Court, the judgment of which is now generally regarded as recognising a novel exception to the "old rules" of privity and consideration which allows third parties to claim on the insurance of others in certain circumstances.[32]

Five distinct reasons for judgment were published by the High Court in *Trident General Insurance Co Ltd v McNiece Bros Pty Ltd* (1988) 165 CLR 107; 62 ALJR 508; 80 ALR 574; 5 ANZ Ins Cas 60-873; 6 BCL 91. In a joint judgment, Mason CJ and Wilson J recognised an exception to the doctrine of privity. Toohey J also recognised an exception to the doctrine of privity, but of a different nature to that recognised by Mason CJ and Wilson J. Gaudron J found that to allow the insurer to resist the claim would result in an unjust enrichment, though she generally endorsed the views of Mason CJ and Wilson J. Deane J, dissenting, did not recognise an exception to the doctrine of privity, but favoured the existence of a trust for the benefit of McNiece. In separate judgments, Dawson and Brennan JJ, also dissenting, found that the insurer was entitled to reject the claim on the basis of McNiece's lack of privity.

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[31] See Warne S, "In Search of the Rationale for the Co-insured Sub-contractor's Immunity from Subrogated Actions in Contractors' All-risks Policies" (1999) 10 Insurance LJ 262.

[32] *Trident General Insurance Co Ltd v McNiece Bros Pty Ltd* (1988) 165 CLR 107; 62 ALJR 508; 80 ALR 574; 5 ANZ Ins Cas 60-873; 6 BCL 91.

On 1 January 1986 (ie the better part of three years before the High Court handed down its decision in *Trident v McNiece*), the ICA came into force. With it came s 48, which effectively eclipsed the findings in *Trident v McNiece*.[33] Section 48 applies to persons who are not parties to the contract of insurance. Subsection 48(1) provides that such persons may recover their loss in accordance with a contract of insurance if they are:

- specified or referred to in that contract;
- whether by name or otherwise;
- as a person to whom the insurance cover provided by that contract extends.

Subsection 48(2) provides that a person who is entitled to cover under the insurance pursuant to the above has, in relation to their claim, the same obligations to the insurer which they would have if they were an insured. Additionally, such a person may discharge the insured's obligations under the insurance.

Significantly, subs 48(3) states that "[t]he insurer has the same defences to an action under this section as the insurer would have in an action by the insured." This provision has been the subject of considerable debate, judicially and academically. The controversy centres upon the ability of an insurer to rely, in defence of a claim brought by a s 48 beneficiary, on:

- the disentitling conduct of an insured; and
- conduct on the part of a section 48 beneficiary which, if done by an insured, would preclude coverage.

The first category of conduct, being conduct by a (contracting) insured, is the principal site of debate in relation to the operation of subs 48(3). There are two ways of interpreting that subsection in relation to the insured's conduct. One is that the conduct of the insured can be asserted against the third party beneficiary regardless of the "innocence" of that third party. This construction is based on the notion that, since rights under s 48 are derivative, a third person cannot recover if an insured cannot. This would make the position of third party beneficiaries akin to the position of insureds under a joint policy. The alternative (and, it is submitted, better) view is that, provided the policy remains in existence,[34] the disentitling conduct of an insured cannot be asserted against a third person who is innocent of that conduct. This construction is based on the notion that subs 48(3) allows the insurer to measure the third person's conduct only against the terms and conditions of the policy in determining that person's entitlement to recover.[35] This would make the position of third party beneficiaries similar to that of insureds under a composite policy such that, whilst the policy remains on foot, it is applied distributively.

The position of third party beneficiaries cannot be equated entirely to that of contracting insureds (whether the joint or composite analogy is preferred), because the statutory duty of disclosure does not apply to such parties. Accordingly, conduct which would otherwise amount to a breach of that duty by a third party beneficiary will not assist the insurer, whereas it would in relation to an insured under a composite policy.[36]

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[33] It should be noted, however, that s 48 did not codify or expressly override the common law in this regard. Accordingly, to the extent that the rule in *Trident General Insurance Co Ltd v McNiece Bros Pty Ltd* (1988) 165 CLR 107; 62 ALJR 508; 80 ALR 574; 5 ANZ Ins Cas 60-873; 6 BCL 91 differs in scope or application from s 48, it may entitle third parties to enforce contracts of insurance where s 48 is inapplicable.

[34] This is sometimes described as a distinction between pre- and post-contractual conduct (see, for example, Sutton, n 5, p 118–119). In reality, the distinction is between, on the one hand, conduct which allows the insurer to treat the contract as void ab initio or to cancel it prospectively (basically, a breach of the duty of disclosure or a pre-contractual misrepresentation) and, on the other hand, conduct which affects a person's ability to recover in respect of a particular claim (eg a failure to comply with a policy condition not remediable under section 54).

[35] Though see n 36.

[36] It should be noted in this connection that it is strongly arguable that an insurer's statutory right to reduce its liability "in respect of a claim" in the event of a (non-fraudulent) non-disclosure or misrepresentation by an insured may apply to a claim brought pursuant to s 48 (see s 28 of the *Insurance Contracts Act 1984* (Cth), summarised in n 15). This approach finds support in Sutton, n 5, p 301, Nicholson K, "Conundrums for Co-Insureds Part III" (1991) 4 Insurance LJ 126 at 133 and in Fotheringham M, "The Insurance Contract - Time for Reform of Section 48" (2000) 11 Insurance LJ 127 at 138 and 141. As

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This issue is complicated by the possibility that third party beneficiaries may owe a duty of disclosure at general law, as an incident of their duty of utmost good faith. This argument relies on the contestable proposition that the codification of the duty of disclosure (in s 21 of the ICA) relates only to insureds and therefore leaves at large the general law disclosure obligations of persons who are not insureds (ie persons who are third party beneficiaries).[37] This issue was considered by the Full Court of the Supreme Court of NSW in the context of a dispute over non-disclosure under a policy of directors' and officers' insurance covering directors of the failed Compass Airlines group of companies.[38] Mahoney JA noted, in *obiter dicta*[39] and without support from the other judges deciding the case,[40] that whilst the s 21 duty of disclosure does not apply to non-parties:

> a third person involved in a transaction of insurance may be bound by the principle of uberrimae fidei (utmost good faith) and, to the extent he is, may be under a duty to disclose facts affecting the insurance; however, the extent of the duty imposed on the third person will depend on the circumstances of his involvement[41]

One question which falls from this is whether or not this general law duty of disclosure attaches only at the inception of the policy or at any point during its life. The relevance of this issue is that a person may come within the scope of s 48 after the inception of the contract (ie they might not be ascertainable or in existence before, or at, inception).[42] This will happen commonly where the "insured" is defined in the contract to include various categories of third party (eg sub-contractors and financiers from time to time).[43] It was not necessary for Mahoney JA to consider this issue, because he held (with the other members of the court) that the directors were in fact contracting insureds rather than third party beneficiaries.[44] Moreover, he found that the policy did not extend to persons

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noted, a claim may be reduced under s 28 to nil if the insurer is able to discharge the significant evidentiary burden of showing that it would not have accepted the risk had the non-disclosure or misrepresentation not been made.

[37] Before coming to this question, however, it is worth pausing to query whether or not a person entitled to enforce a contract of insurance to which the person is not party (by reason of an exception to the doctrine of privity, following certain of the judgments in *Trident General Insurance Co Ltd v McNiece Bros Pty Ltd* (1988) 165 CLR 107; 62 ALJR 508; 80 ALR 574; 5 ANZ Ins Cas 60-873; 6 BCL 91) would, properly characterised, be an insured to whom the statutory duty of disclosure attaches. It is perhaps not necessary to do more than note that issue at this stage, since a person in a position contemplated in *Trident General Insurance Co Ltd v McNiece Bros Pty Ltd* (1988) 165 CLR 107; 62 ALJR 508; 80 ALR 574; 5 ANZ Ins Cas 60-873; 6 BCL 91 will almost invariably fall within s 48 of the *Insurance Contracts Act 1984* (Cth) and the issue will therefore not arise (though see n 33 and n 60).

[38] *C E Heath Casualty & General Insurance Ltd v Grey* (1993) 32 NSWLR 25; 7 ANZ Ins Cas 61-199, per Mahoney, Clarke and Meagher JJA.

[39] All that was necessary to dispose of the appeal was to find that the directors were party to the insurance, which it was found they were.

[40] Clarke JA (with whom Meagher JA agreed) held that it was clear from the provisions dealing with non-disclosure and misrepresentation in the *Insurance Contracts Act 1984* (Cth) "that the obligation to disclose, and not to make misrepresentations, is cast upon a person intending to enter into a contract of insurance and the consequences of non-compliance are visited only upon persons who actually enter into such a contract. What is of greater importance is the fact that there is no obligation to disclose, or not misrepresent, before a contract is entered into, imposed upon a person entitled to recover the amount of a loss pursuant to s 48(1). Nothing in s 28 provides that anything he or she does, or fails to do, before the contract is concluded in any way disentitles him or her from successfully maintaining a claim": *C E Heath Casualty & General Insurance Ltd v Grey* (1993) 32 NSWLR 25 at 46; 7 ANZ Ins Cas 61-199. This comment tends to suggest that, had it been necessary to decide the issue, the other members of the court would have been disinclined to find a general law duty of disclosure.

[41] *C E Heath Casualty & General Insurance Ltd v Grey* (1993) 32 NSWLR 25 at 36; 7 ANZ Ins Cas 61-199.

[42] Sutton, n 5, p 125–126 suggests that the references to a "person", in s 48, includes what he describes as "future persons". This view must be correct, given the breadth of the language of s 48 and the terms of s 20 of the *Insurance Contracts Act 1984* (Cth) (see n 43).

[43] A person need not be specified by name in order to benefit under s 48, because that section refers to a person "specified or referred to in the contract, whether by name or otherwise". Furthermore, s 20 of the *Insurance Contracts Act 1984* (Cth) provides that "[a]n insurer under a contract of insurance is not relieved of liability under the contract by reason only that the names of the persons who may benefit under the contract are not specified in the policy document." Note that s 20 refers to "persons who may benefit under the contract" (which would include s 48 beneficiaries) rather than to "insureds" (which, when used throughout the *Insurance Contracts Act 1984* (Cth), is generally regarded as a reference to contracting insureds: see n 30).

[44] *C E Heath Casualty & General Insurance Ltd v Grey* (1993) 32 NSWLR 25 at 36; 7 ANZ Ins Cas 61-199.

who became directors during the policy period.[45] Accordingly, even if he regarded the directors as third party beneficiaries, his Honour's findings as to the scope of cover would have dispensed with the need to consider the position of persons who are unascertained at inception.

The ICA specifically excludes an ongoing duty of disclosure. Section 21 refers to the insured's duty "before the relevant contract of insurance is entered into". Part II of the ICA, under which contracts of insurance are made subject to an implied duty of utmost good faith, is expressly limited in relation to the duty of disclosure: s 12 (of Part II) provides that "this Part does not have the effect of imposing on an insured, in relation to the disclosure of a matter to the insurer, a duty other than the duty of disclosure". Thus, the s 21 duty of disclosure applies only pre-contract and the requirement of utmost good faith does not expand the insured's disclosure obligations.

If the duty of utmost good faith to which a third party beneficiary may be subject has its source in, or is subject to, Part II (specifically, s 12), it appears that there can be no duty of disclosure at general law, since s 12 prevents the statutory duty of disclosure being expanded and that statutory duty does not, by its terms, apply to third party beneficiaries. On this argument, Mahoney JA's suggestion that a duty of disclosure exists at general law in relation to third party beneficiaries may not be sustainable within the statutory framework established by the ICA.

Section 13 (in Part II) of the ICA provides that a contract of insurance is "based on the utmost good faith" and is subject to an implied provision in the contract "requiring each party to it to act towards the other party, in respect of any matter arising under or in relation to it, with the utmost good faith". There are two ways of construing this section in relation to s 48 beneficiaries. On the one hand, it refers clearly to contracting insureds (ie persons with privity). Since s 48 expressly applies to persons who are not party to the contract of insurance, it would seem that the two sections do not operate together.[46] On the other hand, s 13 implies a term into the contract of insurance and s 48 beneficiaries have "the same obligations to the insurer as [they] ... would have if [they] ... were the insured". If a s 48 beneficiary "were the insured", the contract would oblige it to act towards the insurer with good faith. That being the case, it might be thought that, since the duty of utmost good faith does not expand the duty of disclosure (pursuant to s 12), s 48 beneficiaries are under no duty of disclosure.[47] Whilst superficially attractive, this argument is somewhat elliptical; it places no weight on the references in ss 12 and 13 to the insured and neglects the fact that the duty of disclosure referred to in s 12 is the statutory duty under s 21.[48] Furthermore, it fails to take proper account of the qualification in s 48 that the beneficiary is subject to the same obligations as an insured *in relation to a claim*. For these reasons, the better view seems to be that the ICA does not on its face preclude the existence of a general law duty of utmost good faith on a third party beneficiary, which duty is not subject to the constraints of s 12. Accordingly, there appears to be no reason in the terms of the ICA that a general law duty of utmost good faith could not incidentally require disclosure in certain circumstances, including during the subsistence of the policy. A moment's reflection on the purpose of s 48, however, militates strongly against the imposition of such a duty, particularly considering that the remedies for non-disclosure and misrepresentation under the ICA (ss 28 and 60) would not be applicable in the event of a breach of a general law duty of disclosure by a third party beneficiary. This would likely mean that general law remedies apply, giving the insurer the right to avoid the policy (against the third party beneficiary, at least)[49] in the event even of an innocent non-disclosure. One hopes an outcome so repugnant to the principles underlying the ICA would never be presented for judicial consideration. If it were, an interpretation of the ICA informed heavily by its broad

[45] *C E Heath Casualty & General Insurance Ltd v Grey* (1993) 32 NSWLR 25 at 35; 7 ANZ Ins Cas 61-199.

[46] This argument is put in Mann P, *Annotated Insurance Contracts Act* (4th ed, Lawbook Co., 2003) p 40, where it is suggested that s 13 does not apply to s 48 beneficiaries. To the extent they have a duty of good faith, it derives from the general law (in particular, Mann cites Mahoney JA in *C E Heath Casualty & General Insurance Ltd v Grey* (1993) 32 NSWLR 25 at 48; 7 ANZ Ins Cas 61-199 in support).

[47] This argument is put by Sutton, n 5, p 112.

[48] The phrase "duty of disclosure", which is used in s 12, is defined in s 11 to mean "the duty referred to in s 21".

[49] It seems clear enough that the terms and intent of ss 28 and 60, which allow for avoidance from and inception and prospective cancellation (respectively) in the event of non-disclosure or misrepresentation, would prevent an insurer asserting a third party beneficiary's breach of a general law duty of disclosure against contracting insureds.

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underlying themes rather than its strict terms would be preferable and, it must be said, unremarkable.[50]

Returning then to the effect of non-disclosure or misrepresentation by a third party beneficiary, the position appears to be that a breach by such a person of any general law duty of disclosure which in the circumstances is found to exist will vitiate that person's entitlement to coverage. Put at its highest, such a breach may be constituted in a failure to disclose at any time during which the person falls within the range of persons entitled to the benefit of coverage, or perhaps before. The more probable situation, from the viewpoint of a lender in the position of a third party beneficiary, is that the (or an) insured will breach the duty of disclosure or make a pre-contractual misrepresentation. In that case, any avoidance or cancellation of the policy by the insurer will remove the source from which third party beneficiaries derive their rights. That is, an event affecting the existence of the policy will be visited upon third party beneficiaries with equal force.

In relation to conduct of insureds which affects their entitlement to claim, the position of third party beneficiaries is, as argued above, largely akin to that of insureds under composite policies; broadly, the disentitling conduct of an insured cannot be asserted against a third party beneficiary, though the insurer's statutory right to reduce its liability in respect of a claim following a non-fraudulent breach of the duty or disclosure or a misrepresentation by an insured is likely to be available in relation to a claim by a third party beneficiary. This position finds support in the judgment of Clarke JA (with whom Meagher JA agreed) in *C E Heath Casualty & General Insurance Ltd v Grey* (1993) 32 NSWLR 25; 7 ANZ Ins Cas 61-199. There, Clarke JA gave the example of an insured destroying its own premises by arson and being prevented from maintaining a claim in respect of such destruction by reason of section 56 of the ICA.[51] His Honour went on to note that "nothing in s 56 would appear to affect the right of an innocent mortgagee named in the policy[52] from claiming in respect of the loss it suffered as a consequence of the fire."[53] This position was then declared consistent with Brownie J's finding in *Barroora Pty Ltd v Provincial Insurance (Aust) Ltd* (1992) 26 NSWLR 170; 7 ANZ Ins Cas 61-103; Aust Contract R 90-008 of a several promise to indemnify a third party beneficiary which was not affected by the disentitling conduct of an insured (as in composite insurance).

Clarke JA also endorsed the approach of Giles J in *Commonwealth Bank of Australia v Baltica General Insurance Co Ltd* (1992) 28 NSWLR 579; 7 ANZ Ins Cas 61-133. That case provides further support for the view that the position of third parties in relation to the misdeeds of insureds is substantially the same as that of insureds under a composite policy,[54] that is, the destruction of the contract by one applies to all, whereas the disentitling conduct of one does not affect the other covered persons (absent agency or joint obligations and leaving aside the insurer's statutory rights to reduce its liability in certain circumstances).

One important point to note in this connection is that s 48 does not expand the scope of cover. This notion is best illustrated by reference to two cases dealing with the position of an "innocent"

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[50] The economy of expression in the *Insurance Contracts Act 1984* (Cth) has generated many well-known infelicities. Some of these are the subject of the *Review of the Insurance Contracts Act*, commissioned by the Federal Government on 10 September 2003 and chaired by Alan Cameron AM. An example is s 40, which the High Court read generously in *Newcastle City Council v GIO General Ltd* (1997) 191 CLR 85; 72 ALJR 97; 149 ALR 623; 19 Leg Rep 2; 9 ANZ Ins Cas 61-380; HCA 53.

[51] Section 56 of the *Insurance Contracts Act 1984* (Cth) provides that, where an insured or a person claiming under the Act (ie including a third party beneficiary under section 48) makes a fraudulent claim, the insurer may refuse payment but may not avoid the contract. Section 56 also gives courts a discretion to order the payment (or part payment) of a fraudulent claim if that would be just and equitable in the circumstances.

[52] The context indicates that this hypothetical mortgagee is a third party beneficiary under section 48.

[53] *C E Heath Casualty & General Insurance Ltd v Grey* (1993) 32 NSWLR 25 at 48; 7 ANZ Ins Cas 61-199.

[54] Giles J does note, after describing the position of third party beneficiaries in relation to the non-disclosure of an insured, that the position of another insured in the same circumstances might be otherwise: *Commonwealth Bank of Australia v Baltica General Insurance Co Ltd* (1992) 28 NSWLR 579 at 590; 7 ANZ Ins Cas 61-133. This qualification, however, appears to be reasonably narrow, because his Honour seems to have had in mind the possibility that a contract may contain some clause or be set against some factual background which would give an "innocent" insured some additional rights in relation to the contract. The point may be conceded without detracting from the general proposition that third party beneficiaries face broadly the same exposures as insureds under composite policies to the vitiating conduct of insureds.

lender upon the deliberate destruction of an insured motor vehicle by an insured person. The first case, *Lombard Australia Ltd v N R M A Insurance Ltd* [1968] 3 NSWR 346; 72 SR (NSW) 45; 89 WN (Pt 2) (NSW) 70; [1969] 1 Lloyd's Rep 575, was discussed above. As will be recalled, the financier in that case was taken to be a party to the insurance, which was found to be composite in nature. It was held that the disentitling conduct of an insured in that case did not affect the lender's claim. This was fundamentally due to the several nature of the promise to indemnify, but also depended on a construction of the contract which meant that deliberate damage was not wholly outside the scope of cover on the basis that it was accidental from the claimant financier's perspective. In some cases, the terms of the policy may mean that the disentitling conduct of the insured in fact places the event or the subsequent loss or liability wholly outside the scope of cover. This appears to have been the case in *General Motors Acceptance Corp v R A C Q Insurance Ltd* (2003) 12 ANZ Ins Cas 61-574; QSC 80.[55] In that case, the policy applied to damage caused by an accident, being an unexpected and unintended event from, it was held, the insured's point of view. Since the damage did not answer that description, it was outside the scope of cover and a claim by the financier, whether under s 48 or otherwise, was not available. It is crucial to bear this issue in mind, because policies often define accidents and deliberate conduct by reference to the insured (as described in the policy schedule) which might not include a lender in the position of a third party beneficiary.[56]

Overall, the position appears to be as follows:

	Conduct affecting the coverage	Conduct affecting a claim
Contracting insured	*affected by conduct of insureds* *not affected by conduct vitiating third party's coverage*	*affected by conduct of insureds (unless composite policy, though reductions in liability under the ICA may affect all insureds)* *not affected by conduct vitiating third party's entitlement*
Third party beneficiary	*affected by own conduct and by conduct of a contracting insured*	*affected by own conduct and affected by a non-disclosure or misrepresentation by an insured*

As indicated above, the ICA is presently the subject of a wide-ranging review commissioned by the Federal Government.[57] At the time of writing, the review panel had published a proposal paper

[55] Indeed, in this case, Muir J drew a distinction between an analysis of the scope of cover and the application of a disqualifying event: *General Motors Acceptance Corp v R A C Q Insurance Ltd* (2003) 12 ANZ Ins Cas 61-574 at 76,841; QSC 80.

[56] Whilst the meaning of the term "insured" in the policy will be a matter of construction, it may be relevant to note that the word "insured" is used in various places in the *Insurance Contracts Act 1984* (Cth), including in relation to the duty of disclosure under s 21. It is generally accepted that the reference to the "insured" in s 21 is to a contracting insured rather than a person entitled to coverage pursuant to s 48. Certainly, the language of s 48, which distinguishes between a person referred to in that section and an "insured", bears that out. There is, however, some doubt as to whether or not the word "insured" refers only to contracting insureds in relation to other provisions of the *Insurance Contracts Act 1984* (Cth), chiefly ss 16 and 17. It is not necessary to explore that vexed issue here, but see: Sutton, n 5, p 564–565, *C E Heath Casualty & General Insurance Ltd v Grey* (1993) 32 NSWLR 25 at 45-46; 7 ANZ Ins Cas 61-199, per Clarke JA (with whom Meagher JA agreed) and *Barroora Pty Ltd v Provincial Insurance (Aust) Ltd* (1992) 26 NSWLR 170 at 181; 7 ANZ Ins Cas 61-103; Aust Contract R 90-008, per Brownie J.

[57] See n 50.

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dealing with various provision of the ICA, other than s 54 (which was the subject of a separate review process).[58] Of present relevance, proposal 10.2 of the paper is as follows:

> [s]ubsection 48(3) of the [ICA] should be clarified so that it is clear that a third party beneficiary is in no better position than the actual insured, that is, *insurers should be able to raise the conduct of the insured (whether pre or post contract) in defence to a claim brought by a third party beneficiary.*

This proposal has apparently met with approval in those submissions on the proposal paper which are publicly available.[59] In the circumstances, it seems likely that this proposal will be carried forward into draft legislation. If passed, such amendments would likely have the effect of aligning the position of s 48 beneficiaries with insureds under joint, rather than composite, insurance.[60]

Section 49 of the ICA also impacts on the position of third party beneficiaries (and, potentially, others). That section is designed to respond to the situation in which an insured and a third party each have an interest in insured property. More particularly, the section corrects a difficulty which previously arose where the insured's interest in insured property was less extensive than the insured value of the property. The example often given is that of a lessee insuring leased property for its full replacement value in circumstances where the lessor is not a party to the insurance. In the event of a total loss (for instance), the indemnity principle would prevent the lessee from recovering in respect of the full replacement value of the property and the doctrine of privity would prevent the lessor recovering in respect of its proprietary interest in the whole of the property.

Effectively, s 49 gives third parties (referred to in para 49(1)(b) as "some other person") the right to claim the amount by which the policy limit exceeds the amount of the insured's recovery (which depends on its interest) to the extent of their interest. Thus, if the insured is interested as to $10,000 in property insured for $50,000, a third party interested in the property may bring a claim in respect of their interest in the property against the remaining $40,000 coverage. Section 49 will not operate where the insurance is clearly represented as not covering the interests of persons other than the insured. It is also interesting to note that, whilst the references in s 49 to other persons (not being insureds) would cover s 48 beneficiaries (or beneficiaries in the *Trident v McNiece* sense), it is not necessary that such other person be a third party beneficiary. All that is required is that the other person have an interest in the insured property. Thus, where a lender holds a mortgage over property insured by a mortgagor, it has an interest capable of indemnification under s 49, regardless of whether or not it is a third party beneficiary under the policy.

It is not uncommon for an insured to claim and receive indemnification for the full replacement value of property notwithstanding limitations or defects in their interest. In such a case, if the insurer is not (and could not reasonably be) aware of another person's interest, that other person may (under subs 49(6)) recover an amount from the insured equal to a percentage of the insured's payout calculated by reference to the other person's percentage interest in the relevant property. Take, for instance, a situation in which a person who is not an insured (a mortgagee, for instance) has a 70% interest in insured property worth, say, $200,000 which is insured by a person (in this example, the mortgagor) under a property insurance policy for $100,000. If the insured recovers the full limit of indemnity (ie $100,000) in the event of a total loss,[61] and subsection 49(6) applies, the interested person (the mortgagee) can recover from the insured $70,000, being 70% of the $100,000 payout.

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[58] *Review of the Insurance Contracts Act*, "Proposals Paper on Second Stage: Provisions other than Section 54", May 2004, 84.

[59] Submissions from the Insurance Council of Australia and Catlin Underwriting Agencies Ltd refer to this proposal, but merely endorse it without elaboration.

[60] As noted above (see n 33), s 48 does not expressly overrule *Trident General Insurance Co Ltd v McNiece Bros Pty Ltd* (1988) 165 CLR 107; 80 ALR 574; 62 ALJR 508; 5 ANZ Ins Cas 60-873; 6 BCL 91. If s 48 was amended as per the above proposal, attempts might be made to characterise a third party beneficiary's rights as based on *Trident v McNiece* rather than s 48. It is not clear whether or not such a position would be tenable.

[61] This will normally be subject to the operation of averaging provisions. Average provisions basically provide that, if property has been insured for less than its insurable value (or "underinsured"), the insurer's liability in the event of a claim equals such proportion of the limit of liability as the insured value bears to the actual value. That is, if property worth $100 is insured for $80, and the insured suffers a $50 loss, an averaging provision will allow the insurer to reduce its liability to $40 (being 80% of

Assignment

There are two ways in which assignments can operate in relation to recovery rights under insurance policies. The insured can assign either:

- its rights in respect of a particular claim; or
- its rights generally under the policy.

In the first situation, the thing[62] being assigned is the insured's right to receive money (or money's worth) from the insurer in respect of a specific (past) occurrence. That is, the insurance recovery is being assigned. The assignee will be entitled to recover in respect of the assignor/insured's loss or liability and the amount of indemnity will therefore be measured by reference to the latter's loss.

In the second situation, the insured's rights to recover under the policy in respect of future risks are being assigned. In that case, it is crucial to recognise that an assignment will not alter the scope of coverage and it is therefore the assignor/insured's (rather than the assignee's) rights under the policy which are the subject of the assignment. Thus, the assignee will not replace the assignor/insured under the policy and will not be entitled to coverage for its own losses or liabilities. Rather, the assignee will merely have the right to enforce the policy in circumstances where the insured would be, indeed is, entitled to recover.

Loss payees

Brief mention should be made of the position of loss payees. Fundamentally, the designation of a loss payee under a policy of insurance is an administrative direction to the insurer to pay the proceeds of claims to the designated person/s.

A loss payee is not, by reason of that status alone, covered for the loss payee's own losses or liabilities under the policy. Such persons merely receive funds in respect of the claims of insureds or third party beneficiaries. Depending on the factual situation, and the application of the general law of trusts, funds received by a loss payee may be impressed with a trust in favour of another person (probably an insured or third party beneficiary).

Where a lender is a loss payee, it is not uncommon to find collateral contractual requirements on the lender to hold the funds expressly on trust in a designated account which can be withdrawn from by a specified procedure in specified circumstances (eg to fund the reinstatement of lost or damaged property). Where no such terms exist, and the lender is not under an obligation to account to another party for the policy proceeds, it may be open to it to apply policy proceeds to the reduction of debt.

Finally, it should be noted that a payout will not always result and the loss payee will therefore not always receive funds. This will be the case where the insurer reinstates lost or damaged property rather than making a cash settlement.

3 PROTECTING THE LENDER'S POSITION CONTRACTUALLY

Lenders commonly become involved in large-scale development projects beyond merely providing finance. This involvement might entail participation in project-specific risks, in addition to general credit risk. An example might be where, on the happening of certain credit-related events (such as a borrower's insolvency), the lender's exposure is protected by means of step-in rights, rather than more orthodox security redemption rights over project (or other) assets. In such a case, the lender will have an interest in ensuring that its primary exposure to the full range of project risks is protected in

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$50). The operation of such provisions is affected by s 44 of the *Insurance Contracts Act 1984* (Cth), which limits the operation of averaging provisions in relation to residential property and, more generally, prevents insurers relying on such provisions where they have not provided the intending insured with clear notice of the nature and effect of such a provision in a contract of insurance. It should be noted that averaging provisions sometimes impose co-insurance obligations on the insured in respect of the proportionate underinsurance. See n 4 regarding co-insurance.

[62] Rights under a policy of insurance are a form of personal property capable of enforcement by action. That is, they are choses in action.

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the event of its exercising any step-in rights. Even if the lender is not exposed to primary risks in relation to a financed project, its overriding credit exposure would justify an interest in ensuring that insurances are in place to guard against the borrower's exposure to the financial consequences of an insurable event. Even where the borrower has significant scale and its cash position would enable it to absorb significant liabilities, its exposure to catastrophes must be managed.

This article has generally proceeded on the assumption that insurance is regarded as a worthwhile means of managing risk. It may be useful, however, to note in passing what the purpose and benefits of insurance would be (from the lender's perspective) in the context of a major project. To a large extent, the purpose of insurance in this context is to assist the lender in reducing credit risk by limiting the contractor's exposure to adverse events relating to the project. Unlike a guarantee by a parent entity (for instance), risk transfer by way of insurance places the risk wholly outside the group to which the lender is exposed, rather than allocating responsibility within that group.

Against the above background, this Part deals with a number of issues relating to the imposition of insurance obligations under contracts, which can affect the insurer's position in relation to other people's insurance.

The broad framework of clauses imposing insurance obligations is as follows: a defined party (usually designated the "contractor") must effect and maintain specified insurances. Often, certain of these insurances are required to be extended to cover other parties (usually, the "principal" and others, often including "financiers", "for their respective rights and interests"), and may be required to be on certain terms and with certain insurers (or as approved by the principal). These clauses sometimes also deal with the interests of lenders in the proceeds of insurance policies. The remainder of this Part analyses these clauses in more detail.

At a minimum, insurance clauses will stipulate the forms of insurance required. It may be noted in passing that such stipulations should actually impose an obligation on a specified party to effect certain insurances, rather than merely containing a representation that insurances have been, or are intended to be, effected. In the case of a financed project under which the lender is significantly exposed to the risks affecting the project, both indirectly (ie its credit risk flowing from the borrower's exposure to project risk)[63] and directly (ie any security interest it has in the project property), the insurances upon which the lender may insist include the following:

- Contractors' all risk insurance, which is a bundled policy covering the insured's liabilities to third parties (generally, in respect of personal injury or property damage) arising in connection with project activities, as well as first-party losses arising from the loss of or damage to project works. Since the first-party loss cover is designed for use in connection with construction projects, cover typically extends to temporary works (such as supporting structures). The first-party loss component usually contains an express basis of settlement clause, which usually allows for replacement/reinstatement of the subject property to a condition equivalent to but not better or more extensive than its pre-damage condition.
- Contract works insurance, which basically provides the first-party loss cover described under contractors' all risk insurance (above), but without the bundled liability cover. As with contractors' all risk insurance, this form of insurance is typically written on a project-specific basis, which means that it does not usually provide cover for the contractor's activities outside the scope of the project.
- Property insurance, being a broad category of insurance of which contract works insurance is an example. It is separately listed here, to distinguish between property insurance effected in connection with a construction project and property insurance effected to cover completed structures and other property. As with all forms of property insurance, it is important to pay careful attention, not only to the property which the policy is expressed to cover, but also the perils. The perils are the risks affecting property, such as fire and flood.

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[63] In this connection, the borrower may for the purposes of this analysis be either the contractor or the principal, since each is exposed to counterparty risk in relation to the other, which exposes the lender to credit risk, regardless of its origin.

- Industrial special risks insurance, which is another form of property insurance. It is distinguished by its two insuring sections which provide property insurance as described above ("section one") and consequential loss, or business interruption, insurance ("section two"). Section two is usually invoked upon the loss of or damage to property insured by section one, but may also be extended to be invoked on the happening of specified external events, such as an interruption in supplies or utilities. Section two cover is usually subject to detailed basis of settlement stipulations, which generally provide for cover against a loss of profits due to property damage or destruction (or such other events as are stipulated). For example, if a manufacturing business suffers the loss of a particular piece of equipment and that loss causes it to cease its normal manufacturing processes for a period, section one would (subject to its terms) cover the loss of the equipment and section two would (again, subject to its terms) cover consequential losses (principally, the loss of profits, but also expenses incurred in minimising future losses, such as purchasing manufactured replacement goods for on-sale in order to maintain custom).[64]
- Transit insurance, which might be relevant if materials of significant value are to be acquired by the contractor off-site then transported to the site. Consideration must be given to the form of transit likely to be used, since the form of cover may depend on whether transit is by land, sea or air. Typically, this insurance is written by Lloyds underwriters and provided on standard-form clauses.
- Professional indemnity insurance, which is a form of liability (as distinct from first-party loss) insurance. It covers the insured's legal liabilities to third parties arising from economic losses suffered by such parties as a result of negligent or otherwise defective professional services being rendered by the insured.
- Public liability insurance, being another form of liability insurance covering the insured's legal liabilities to third parties in relation to personal injury or property damage suffered by them as a result of conduct by the insured.
- Workers' compensation cover, being a form of compulsory liability insurance (in some jurisdictions, it is more in the nature of statutory cover rather than insurance as such). It covers the insured's liabilities to employees and others imposed by workers' compensation statutes.
- Employers' liability insurance, which responds to the insured's legal liabilities to employees and others not covered by workers' compensation cover. Generally, these are liabilities imposed at common law rather than under statute. In some jurisdictions, the compulsory workers' compensation cover extends to common law liabilities[65] and it is therefore unnecessary to specify employers' liability insurance in respect of such jurisdictions.

The forms of insurance required will, of course, depend on the nature of the financed asset or endeavour. For instance, the above insurances may have little or no relevance in relation to a business or share acquisition financed wholly or partially through debt. In such a case, the major exposures of the acquirer (and, consequently, of the acquirer's financier) may be the subject of warranties given by the vendor. The financier may seek to have the acquirer guard against its exposure to the risk of vendor insolvency associated with a breach of warranty through a requirement that warranty and indemnity insurance is purchased by either the vendor or the purchaser.

To take another acquisition-related example, a borrower might wish to acquire land (for instance, as part of a project-financed project). The useability of the land might be crucial to the borrower's ability to service the debt. In such a case, an unknown environmental loss or liability (or a known but

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[64] A related form of cover which may be relevant is advance profits insurance, which provides business interruption cover in respect of profits lost through reductions in *anticipated* turnover which are caused by delays in constructing or developing production capacity. Thus, where a factory is being constructed (for instance) and an insured peril results in the completion date (and, therefore, the commencement of production) being set back, this insurance provides cover in respect of the period between when production was meant to commence and when it actually does commence (subject to policy limits, etc).

[65] NSW is an example, where the terms of the standard compulsory cover, as set out in Form 3 under the *Workers Compensation Regulation 2003* (NSW), provides statutory (clause 3(a)) and common law (clause 3(b)) cover.

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unquantifiable loss or liability) might be the subject of insurance required by the lender to be effected by the borrower.

It is relevant to note in passing that the effect of the *Terrorism Insurance Act 2003* (Cth) (TIA) is that, if an eligible contract of insurance[66] excludes cover for terrorism on its terms, that exclusion will be struck down (subject to the terms of the ICA), thereby forcing the insurer to provide terrorism cover, subject to the other terms of the policy (which define the scope of cover and remain unaffected). A liability of an insurer under the TIA may be reinsured by a government-established reinsurer constituted under the TIA. The TIA applies to insurance in relation to most commercial properties, and could have application to contractors' all risk, contract works, general property, industrial special risks and public liability classes of cover. The position of mortgagees in relation to the TIA is problematic. The notion of ownership, as defined in the TIA, includes (on one interpretation) a mere insurable interest, which a mortgagee would have. Whether the TIA actually applies to insured mortgagees, however, is a complex question. Similarly, there are difficulties (which are beyond the scope of this paper) in applying the TIA where the insurance is part of a global programme.

Listing the types of insurance required is not enough to ensure adequate coverage is provided. A requirement that professional indemnity insurance be effected and maintained for a specified period, for instance, could be satisfied by the purchase of grossly inadequate cover, say, with a limit of indemnity of $100,000 underwritten by an unauthorised foreign insurer of dubious history and solvency.[67] This highlights the need to specify the minimum limit of indemnity, upon which it is usually best to engage insurance brokers to advise. Additionally, it is important to specify the period of insurance. The period of insurance will vary depending on the type of insurance involved. As a general rule, occurrence-based insurances should be maintained for the duration of the project (or such other period during which an adverse event could occur) whereas claims made insurance should be maintained for a trailing period. This general rule derives from the nature of the insurance involved, which may be summarised as follows:

- Occurrence based insurance responds to events which occur during the period of insurance. Thus, if a person is injured at T1 and makes a claim at T2, the occurrence-based insurance on foot at T1 applies (subject, of course, to its terms). Third party liability and property insurances are generally written on an occurrence basis, largely because events giving rise to claims are generally immediately apparent and therefore able to be brought to the insurer's attention during the period of insurance.
- Claims made insurance responds to claims made during the period of insurance. Thus, if a person negligently provides architectural services at T1 which leads to a claim at T2, the claims made insurance on foot at T2 would respond (subject to its terms). Professional indemnity insurance is generally written on a claims made basis. Such policies generally also allow for circumstances

[66] Section 7 provides that the *Terrorism Insurance Act 2003* (Cth) applies to "eligible insurance contracts", being insurance contracts which provide cover for: loss of, or damage to, "eligible property" (being buildings and associated tangible property located in Australia) owned by the insured; business interruption and consequential loss arising from loss or damage or loss of use of eligible property owned or occupied by the insured; or a liability of the insured arising out of the insured being the owner or occupier of eligible property. The *Terrorism Insurance Regulations 2003* (Cth) provide exceptions to the term "eligible insurance contract". Included amongst these exceptions is one for home building insurance (as defined in regulation 7.1.12 of the *Corporations Regulations 2001* (Cth). This is consistent with the broad purpose of this legislation, being to enable property owners to secure terrorism insurance cover for losses of or damage to commercial realty (and associated business interruptions and third party liabilities).

[67] It is lawful for unauthorised foreign insurers to underwrite Australian risks (subject mainly to compliance by local agents with the requirements of Ch 7 of the *Corporations Act 2001* (Cth)). Such insurers were one of the subjects of the *Review of Discretionary Mutual Funds and Direct Offshore Foreign Insurers* commissioned by the Federal Government. That review relevantly recommended that APRA's powers over unauthorised foreign insurers (or "direct offshore foreign insurers") be expanded. The Government has indicated an intention to adopt this recommendation, which may make cover from such insurers less readily available in Australia: The Hon P Costello, MP, "Government progress in implementing the HIH Royal Commission recommendations" (Press Release 042, 27 May 2004).

which may give rise to a claim to be notified to insurers during the currency of a policy and for any subsequent claim arising from those circumstances to be deemed to have arisen during the period of insurance during which notification of circumstances was given.[68] This is designed to enable insurers to know at the end of a period of insurance what claims are likely to be chargeable against premiums received in that period. If such risks were written on an occurrence basis, the often latent nature of such claims would mean that the insurer would remain exposed to claims for an indefinite period of years after the policy period had been treated as closed (subject to "incurred but not reported" provisions).

As intimated above, it is prudent to exercise some control over the choice of insurer. Often, the contractor is required to maintain insurance with insurers approved by the principal. Where the lender is able to have some influence over the drafting of such requirements, it might be best for the lender if the contract was to lay down objective criteria by which the principal is also bound. These might include specifying the insurer's place of domicile and regulation[69] and its credit rating, for instance.[70] The terms of the insurance will also be of obvious importance to the adequacy of required coverage. A term of a policy, either contained in the standard wording or endorsed to the policy, might make the cover practically illusory in the circumstances of any given risk matrix. It can be difficult, however, to specify objective criteria against which to judge the adequacy of the terms of cover.[71] Typically, the terms of cover are made subject to approval by the principal. This involves risk to the lender, if the principal is unable or unwilling to exercise proper judgment in this regard. If such a risk is perceived, and again assuming some influence on the lender's part, it might be best to provide for the appointment of an independent expert to review terms (such as an insurance broker).

As discussed in Part 2, insurance requirements serve not only the purpose of managing counterparty risk by requiring the borrower to be insured in respect of certain losses and liabilities, but can also be used to provide the lender with cover under the borrower's insurance. It is not uncommon for lenders to be included amongst the range of parties required to be "noted" under a policy of insurance required under contract. The terms "noted" and "named" are commonly used in

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[68] Claims made policies which do not contain such provisions are subject to subs 40(3), which effectively provides for such circumstance notifications to be made. Given this provision, it was previously common practice for insurers to include circumstance notification provisions in claims made policies, because it was believed that the position would be the same under subs 40(3) if such a provision (which was probably believed to be good for marketing) was absent. Following the High Court's decision in *FAI General Insurance Co Ltd v Australian Hospital Care Pty Ltd* (2001) 204 CLR 641; 180 ALR 374; 75 ALJR 1236; 22(13) Leg Rep 13; 11 ANZ Ins Cas 61-497; HCA 38 it became clear that a failure of an insured to notify of circumstances pursuant to a circumstance notification clause in a contract of insurance could be the subject of relief under s 54 of the *Insurance Contracts Act 1984* (Cth) (see Scott, n 14). A view was formed that, by removing circumstance notification provisions from contracts and therefore importing a similar mechanism through subs 40(3), s 54 would not apply on the basis that it attached to "the effect of a contract of insurance" rather than the operation of law. This view seems to have been correct: see *CA & MEC McInally Nominees Pty Ltd v HTW Valuers (Brisbane) Pty Ltd* (2001) 166 FLR 271; 188 ALR 439; ANZ Ins Cas 61-507; QSC 388 per Chesterman J and *Gosford City Council v GIO General Ltd* (2003) 56 NSWLR 542; 12 ANZ Ins Cas 61-566; NSWCA 34 per Spigelman CJ, Meagher and Sheller JJA. The *Review of the Insurance Contracts Act*, n 50, recommended reforms to s 54 to moderate its operation, which might see the re-introduction of circumstance notification provisions in claims made policies (see n 14).

[69] Australia's prudential regulation of general insurers may be regarded as world leading. Accordingly, there are few jurisdictions providing comparable supervision over insurer solvency. The United Kingdom is moving to a system philosophically similar to Australia's risk-weighted approach to capital adequacy. Also, its position at the centre of the insurance world means that it is generally regarded as an acceptable jurisdiction for these purposes.

[70] In determining an appropriate credit rating for an insurer, it may be noted that Guidance Note GGN 110.4 (being a document which explains the operation of Prudential Standard GPS 110, with which authorised general insurers are required to comply pursuant to s 34 of the *Insurance Act 1973* (Cth)), reinsurance placed with insurers of less than a Standard & Poor's rating of "A-" attracts an investment capital factor (ie a reduction in value for capital adequacy purposes) of 6%. To put that in perspective, listed equities, which are regarded as highly volatile, attract a factor of 8%. The capital charges may reflect APRA's view as to the probability of insurance placed with insurers rated at various levels being unrecoverable due to insolvency.

[71] A common example of a stipulation designed to regulate the terms of cover is a "non-averaging" requirement, which is designed to prevent averaging clauses in insurance from affecting the extent of cover. See n 60 for a description of averaging clauses.

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this connection, by insurers, brokers and others. As noted above, those terms do not reflect the state of Australian law in this area. Rather, third party beneficiaries generally derive their rights from s 48 of the ICA. That section uses a different form of language and does not draw a distinction between different forms of acknowledgment or reference. In Australia at least, the first question is whether or not a person is a contracting insured. If the person is not, the next is whether the person is a person to whom the benefit of cover is expressed to extend, for the purposes of s 48.[72] If the person is, then the person has rights under that section (discussed above). If not, the person has no such rights under the ICA and must rely on the general law. Where it is intended that a person who will not be a contracting insured will be covered by insurance, the best formulation is to adopt the language of s 48 in imposing a requirement on the insured to procure that specified insurances cover third parties. The insurances in respect of which such a requirement is usually, or ought to be, imposed will be property insurance (covering financed property) as well as third party liability insurance. Where the lender has step-in rights, it may be necessary to extend other insurances to the lender, or to provide for the inception of further policies covering the lender's increased exposure upon stepping in. Additionally, if the lender wishes to be able to enforce and recover under a policy covering another's losses and liabilities, it may be prudent to seek an enduring power of attorney enabling the lender to assign that other party's relevant rights to the lender at will.

Where multiple parties are covered by a single policy of insurance (such as where a contractor is a contracting insured and various parties, including a lender, are s 48 beneficiaries), it is usually appropriate to require the primary insured to procure that certain safeguards are in place to preserve the insurance, and the interests of the various parties in it. The following provisions are generally referred to:[73]

- A cross liabilities clause, pursuant to which the insurer agrees to reverse the effect of a clause commonly included in liability policies excluding claims brought by a person covered by the insurance.[74]
- A waiver of subrogation clause, whereby the insurer waives its right to be subrogated to its insureds' rights against other parties where those other parties are also entitled to the benefit of cover. It should be noted that such clauses may be effective to the extent only of the other party's interest insured under the policy. That is, if the other party's insured interest does not extend to matters raised in a subrogated action, a general waiver of subrogation clause might not prevent the insurer from exercising such rights. This is relevant to mortgagees whose interest in the subject property is limited.
- Notification clauses, which allow for notifications to and from one covered party to be treated as notifications to and from all covered parties. Additionally, a lender or other party might seek to have the obligee procure the insurer to agree that cover will not be cancelled without notification to such other party. In the current market, insurers are generally disinclined to accept the additional administrative burden this implies.

Where the multiple parties are in fact contracting insureds and are therefore subject to the statutory duty of disclosure, the following stipulations are normally included in addition to the above. These clauses are generally not useful where the covered parties are third party beneficiaries (although a non-imputation clause can have its uses in that context), provided one accepts that such parties are not under a general law duty of disclosure, as discussed above:

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[72] As noted above (see n 33), there may be a third category of persons who are third party beneficiaries for the purposes of *Trident General Insurance Co Ltd v McNiece Bros Pty Ltd* (1988) 165 CLR 107; 62 ALJR 508; 80 ALR 574; 5 ANZ Ins Cas 60-873; 6 BCL 91 but not for the purposes of s 48. On the law as it stands, this question is largely academic; however, proposed amendments to s 48 may stir interest in the existence and scope of this possible category (see n 60).

[73] These measures are also summarised in Hawke F, *Managing the Risks of Insurance*, http://www.claytonutz.com/downloads/WallSammut.pdf viewed 18 June 2004.

[74] Such clauses, termed "insured vs insured" clauses, are designed to prevent related insureds converting third party liability cover into first-party loss insurance by contriving causes of action amongst themselves in the event of a loss of property in order to access the insurance.

- A severability clause, under which an insurer treats the insurance as written on the basis of a separate proposal form received from each insured in identical terms. This is designed to protect innocent insureds from fraudulent non-disclosures and misrepresentations by other insureds on the basis that the proposal was, when measured against the innocent insureds' knowledge, correct and therefore tainted by non-fraudulent non-disclosure or misrepresentation at most.
- A non-imputation clause, which is used in conjunction with a severability clause to prevent its being circumvented by the fraudulent insured's knowledge being imputed to the innocent insured/s.
- A clause waiving rights in respect of non-material non-disclosures and misrepresentations by an insured, which is usually subject to the insurer's right to adjust the premium.

In all events it is appropriate to seek evidence of compliance with insurance obligations. Generally, such evidence is provided to the principal, but there is no reason that evidence could not be provided to a lender or, for instance, to an independent expert (again, such as an insurance broker) who assesses compliance with insurance obligations and reports to specified parties, which may include the lender. Certificates of currency are often used in this area. Whilst they are useful, it must be recognised that they serve a limited purpose. Essentially what they involve is a third party (the broker) making a representation regarding the period of insurance, and often the limit of liability and deductible, of a defined policy. In order to assess the actual terms of coverage, it is necessary to review the policy wording and any endorsements and schedules which may affect the policy's operation and terms. Insureds are very often disinclined to disclose policy wordings, sometimes because they simply do not have copies. It should be noted however that it is not unusual for liability policies to require that the insured not disclose the terms, or even the existence, of the policy, apparently on the basis that third parties might frame claims against insureds in order to target the insurance.

A failure to comply with insurance requirements may give rise to an action in damages; however, given the overriding purpose of managing counterparty risk and risk to one's own insurable interests, such rights would be cold comfort to a lender. Generally the best option is for the contract to provide a right of a counterparty to effect and maintain the required insurances in the event that the relevant party fails to do so. Such clauses typically also state that the premiums paid or payable under such insurances are recoverable as a debt due from the defaulter. It is best if these rights are triggered by a failure of the defaulter to provide evidence of insurances, as required under the contract, rather than by a failure to comply. This would avoid placing the obligor in the invidious position of having to determine whether or not there has in fact been non-compliance with procurement obligations where there has been a failure to provide evidence.

4 CONCLUSION

Lenders have a clear interest in their borrowers' exposures to property loss and liability. Sometimes this interest is properly and directly the subject of insurance, such as where the lender holds a mortgage over property. In other cases this interest is merely commercial, in that the borrower's exposures expose the lender to credit risk. Part 2 of this article introduced the ways in which these interests can manifest themselves. A lender might be a party to a contract of insurance alongside a borrower (such as where the borrower acts on its own behalf, and as the lender's agent, in arranging insurance). Alternatively, and more probably, the lender might be a third party beneficiary to insurance. Part 2 outlined the relative positions of insureds and third party beneficiaries in the event of vitiating or disentitling conduct by another covered party. Part 2 also outlined two other potentially relevant interests arising in cases where the lender is interested in, but not covered by, the relevant insurance (where the lender is an assignee or a loss payee).

Part 3 suggested a range of contractual means by which a lender's commercial and legal interests in borrowers' insurances may be protected. If followed, these measures would represent a considerable advancement in the level of sophistication of insurance requirements lenders are accustomed to imposing. In the case of a major project, however, it seems that a simple cost-benefit

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analysis could, in appropriate circumstances, suggest that it is well worth drafting and enforcing detailed stipulations as to insurance.