

THIRD PARTIES AND THE INSOLVENT INSURED

ENFORCEMENT OF THE STATUTORY CHARGE CREATED BY SECTION 9 OF THE LAW REFORM ACT 1936

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With its ancestry based in the early Workers' Compensation Acts, s 9 of the Law Reform Act 1936 was intended to be a general rule to provide that where there is a wrong perpetrated by a person who is insured, the injured person can have a lien on the insurance moneys. This article discusses the scope and functions of s 9, identifies some problems and suggests that, after 60 years, it is time to review this piece of legislation.

I THE LEGAL RELATIONSHIP BETWEEN THE INSURER AND THE THIRD PARTY

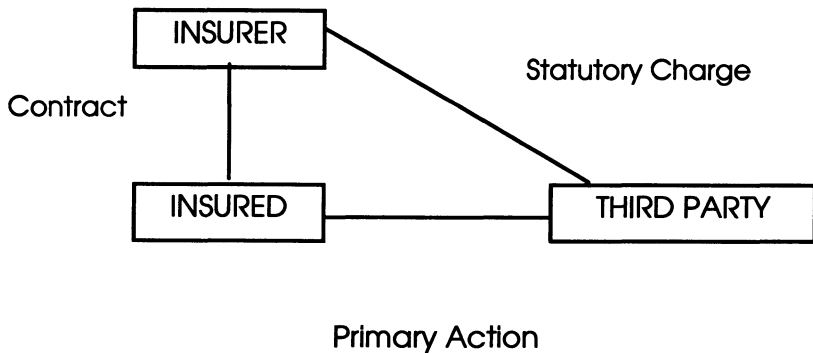
Where the insured is indemnified under a contract of insurance, s 9 of the Law Reform Act 1936 creates a statutory charge over the insurance money "on the happening of an event giving rise to a claim for damages, or compensation" (the event). The creation of a charge effectively takes the insurance money out of the assets of the insolvent estate, in the same way that assets subject to a security in favour of a third party do not form part of the assets for distribution to the general body of creditors.

The relationship between the insured and the insurer is governed by the contract of insurance (the contractual action). The relationship between the insured and the third party is determined by the law giving rise to the claim by the third party against the insured (the primary action). If the liability of the insured is established in the primary action, the insurer may make payment directly to the third party, but the third party cannot insist upon

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that as the third party is not a party to the contract of insurance which confers on the insurer the obligation to pay.

Unlike the English legislation,¹ s 9 of the New Zealand Law Reform Act 1936 does not assign the insured's rights and obligations under the contract of insurance to the third party. Section 9 creates a charge over the insurance money payable to the insured under the contract of insurance. The charge arises by virtue of the statute and exists independently of the contractual relationship between the insured and the insurer. The relationship can be expressed as follows:



Section 9(4) enables the third party to enforce the charge by way of action against the insurer, and the parties to the action "shall, to the extent of the charge, have the same rights and liabilities, and the Court shall have the same powers, as if the action were against the insured." This provision allows the insurer to stand in the shoes of the insured in respect of the primary action and raise any defence to the primary action that was available to the insured.

In denying the existence of a charge, can the insurer rely on any defence it would have to an action by the insured to enforce the contract of insurance? In contrast to the New South Wales legislation,² s 9 does not expressly allow the insurer to raise, as a defence to an

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- 1 The Third Parties (Rights against Insurers) Act 1930 (UK) provides that, upon insolvency, the insured's rights against the insurer are "transferred and vested" in the third party. The rights transferred to the third party are subject to any defence available to the insurer to an action by the insured to enforce the contract of insurance. *Post Office v Norwich Union Fire Insurance Society Ltd* [1967] 2 QB 363; [1967] 1 All ER 577 (CA). In effect, the third party stands in the shoes of the insured and can have no better claim against the insurer than the insured has under the contract of insurance.
 - 2 The proviso to s 6(4) of the Law Reform Act (Miscellaneous Provisions) Act 1946 (NSW), states: "[L]eave shall not be granted in any case where the court is satisfied that the insurer is entitled under the terms of the contract of insurance to disclaim liability".

action by the third party (the statutory action), any defence it would have to an action by the insured to enforce the contract of insurance.

Although there is no equivalent provision in the New Zealand legislation, the courts have accepted that where the insurer is not liable to the insured the statutory action will fail. The insurer can rely on defences it would have to an action by the insured to enforce the contract of insurance because s 9(1) provides that the charge arises "on all insurance money that is or may become payable" in respect of the insured's liability to the third party. If the insurer is not liable under the terms of the policy, then no insurance money becomes payable and consequently no charge arises.³

However, in allowing the insurer to raise, as a defence to the statutory action, those defences available to it in the contractual action, the courts have assumed that the third party stands in the shoes of the insured. Because s 9 does not assign the insured's rights to the third party, it is not correct to state that the third party stands in the shoes of the insured vis a vis the insurer.

To summarise:

- (a) the insurer stands in the shoes of the insured and may raise any defence available to the insured in respect of the primary action;
- (b) the insurer can deny the existence of a charge in favour of the third party by raising any defence it would have to an action by the insured to enforce the policy;
- (c) strictly speaking, the third party does not stand in the shoes of the insured in respect of an action to enforce the contract of insurance, as the third party's rights arise not under the contract of insurance but under the statutory cause of action created by s 9;
- (d) the nature and scope of the relationship between the insurer and the third party is accordingly defined by s 9 and not by the contract between the insured and the insurer.

The absence of a contractual relationship between the insured and third party raises several difficult issues:

- (a) will a breach of the contract of insurance by the insured enable the insurer to avoid the charge;⁴

³ See Part III of this article.

⁴ See Part III of this article.

- (b) what, if any, limitation period applies to the statutory action;⁵
- (c) what is the effect of contractual provisions which avoid the operation of the charge created by s 9.⁶

These issues are relevant both to the exercise of the court's discretion to grant leave and to the statutory action to enforce the charge.

II FACTORS RELEVANT TO THE EXERCISE OF THE DISCRETION TO GRANT LEAVE

Proceedings against the insurer require leave of the court unless the case fits within one of the circumstances set out s 9(2).⁷ The Act does not specify the factors which are relevant to the exercise of the discretion to grant leave, but the courts have established a number of principles which will briefly be discussed.

A *Establishing an Arguable Case*

The third party must establish an arguable case against the insured before leave will be granted to issue proceedings against the insurer.⁸ Although the third party must establish an arguable case in respect of the primary action, the onus is not a high one.⁹ It appears that an arguable case can be established on the pleadings, although the cases note that the provision of some affidavit evidence is desirable.¹⁰

If the contract of insurance does not cover the insured's liability in respect of the primary action, there is no contract of insurance under which the insured is indemnified and no question of the charge arising. In *Independent Wool Dumpers Ltd v American International underwriters (NZ) Ltd & Ors*,¹¹ the contract of insurance expressly excluded damage resulting from the replacement or repair of products sold by the insured. The third party purchased a defective product from the insured and claimed that the insured (and

5 See Part IV of this article.

6 See Part V of this article.

7 s 9(4).

8 *Registered Securities Ltd v Brockett* Unreported, 17 October 1991, High Court, Christchurch Registry, CP 298/87; *Yates New Zealand Ltd v Wang New Zealand Ltd and Cooke Heating Ltd (in receivership)* (1993) 7 ANZ Insurance Cases 61-196. In both cases, leave to issue proceedings against the insurer was refused.

9 Above n 8, see also *Plastic Recoveries & Manufacturing Ltd & Anor v Wright Machinery Ltd & Ors* (1991) 6 ANZ Insurance Cases 61-051 ("Plastic Recoveries").

10 *Campbell v Mutual Life and Citizens Fire and General Insurance (NZ) Ltd* [1971] NZLR 240, 243; *Yates* above n 8, 78,246-78,247; *Registered Securities* above n 8, 12.

11 (1993) 7 ANZ Insurance Cases, 61-152 (HC).

thereby the insurer) was liable for the repair and replacement costs of the defective product. Although the third party had a claim against the insured, it was not a liability which the insurer had agreed to cover.

In both *Independent Wool Dumpers*¹² and *AFG Insurances Ltd v Andjelkovic*,¹³ it was held that the third party must establish that the event is an insured risk as a threshold issue to the granting of leave to commence the statutory action. In *Independent Wool Dumpers* it was a question of law whether the contract of insurance covered the insured's liability in respect of the primary action. In *AFG Insurances Ltd* it was a question of fact whether the event was an insured risk and whether a contract of insurance was in force at the time of the happening of the event. The Federal Court of Australia there held that leave would not be granted where the third party was unable to show any arguable case that the event was within the terms of the contract of insurance.

In *Plastic Recoveries*¹⁴ the insurer declined the claim on the basis that certain conditions in the contract of insurance had been breached by the insured. Master Towle stated that the onus was on the insurer to show that it was entitled to decline the insured's claim under the contract of insurance. Similarly, in *State Insurance General Manager v Maaka*¹⁵ the Court of Appeal stated that if the insurer could establish it was entitled to disclaim liability under the terms of the contract of insurance, leave would be declined.

The cases therefore establish that at the stage of applying for leave the third party need only establish:

- (a) an arguable case in respect of the primary action;
- (b) the existence of a contract of insurance;
- (c) the event is an insured risk.

If there is a factual dispute as to any of these matters, then the proper course is for leave to be granted. However if there is no factual dispute, or if it is established as a matter of law that there is no liability to the insured, then leave to proceed against the insurer will be refused.

12 Above n 11.

13 (1981) 1 ANZ Insurance Cases 60-443.

14 Above n 9.

15 (1989) 5 ANZ Insurance Cases 60-943 (CA).

B *The Existence of a Financially Sound Defendant*

The insured must be of doubtful solvency before the courts will entertain an application for leave to commence a statutory action against the insurer.¹⁶ However, it is not necessary for the insured to be bankrupt or in liquidation before leave will be granted to enforce the charge. In *Manettas v Underwriters of Lloyds (contract no 68011140) & Anor*¹⁷ the court rejected the insurer's argument that the insured should be put into bankruptcy before leave is granted to issue proceedings against the insurer.

Nor is the existence of other potential defendants a ground for refusing leave to issue proceedings against the insurer. In *FAI (NZ) General Insurance Co Ltd v Blundell and Brown Ltd*¹⁸ the third party obtained judgement against the insured before applying for leave to enforce the charge against the insurer. FAI argued that the third party should exhaust its rights against other potential defendants before leave was granted to issue proceedings against the insurer. That argument was rejected in the Court of Appeal by Richardson J "If the insured is apparently impecunious there can be no justification for postponing recourse against the insurer and expecting the claimant to bear the cost of pursuing other possible defendants."¹⁹ The other members of the court agreed that to refuse leave on this basis would deprive the third party of its election as to which party to sue and create an unjustified windfall for the insurer.²⁰

The existence of other potential defendants will not enable the insurer to avoid the operation of s 9. If a defendant (A), other than the insured (B), fully compensates the third party, then (provided A has a right to contribution from B) A can claim the benefit of the charge against the insurer of B. In *National Mutual Fire Insurance Co Ltd v Commonwealth of Australia*,²¹ the Commonwealth, having been found liable to the third party, was able to claim a charge over any insurance money due to the insured, even though the insured had not been joined to the original proceedings. It was held that the insured's liability to pay damages included any contribution which the insured might be required to pay as a joint tortfeasor.²²

16 *Campbell v Mutual Life and Citizens Fire and General Insurance Company (NZ) Ltd* [1971] NZLR 240, 243; *Oswald v Bailey* (1987) 11 NSWLR 715; 4 ANZ Insurance Cases 60-807.

17 (1993) 7 ANZ Insurance Cases 61-180.

18 [1994] 1 NZLR 11 (per Hardie-Boys J).

19 Above n 18, 15.

20 Above n 18; see also *David J Reid (NZ) Ltd v CE Health Casualty and General Insurance (NZ) Ltd* (1992) 7 ANZ Insurance Cases 61-137.

21 (1981) ANZ Insurance Cases, 60-438 ("National Mutual").

22 See also *Hatea Motors Ltd v Foote* (1992) 7 ANZ Insurance Cases, 61-130.

C General Discretion

The discretion under s 9 is limited only by the need to exercise it in a manner which is consistent with the policy of the legislation.²³

The facts in *National Mutual* provide a good illustration of the factors which the court might regard as relevant to the exercise of its general discretion to refuse leave.²⁴ In that case the party seeking to enforce the charge was the insured's employer who did not wish to sue the insured directly. There was also a significant delay (some 12 years) between the primary action arising and the insurer being advised of the existence of the claim. Moffit J held that the existence of a special relationship between the insured and the third party was not a sufficient reason to allow the insurer to be sued directly. Delay in bringing the statutory action will be relevant as potentially showing that the insurer is prejudiced in having to defend a claim of which it has no knowledge and little assistance with from the insured.

Anderson J in *Yates*²⁵ doubted whether a general discretion to refuse leave existed under s 9. The insured could not seek to escape liability on the grounds of difficulty in tracing witnesses, and in his view the insurer should not be able to resist the grant of leave on the grounds of inconvenience any more than the insured could.

The Parliamentary Debates support Anderson J's view that the purpose of s 9(4) is to ensure insurers were not sued directly when the insured is solvent, the reason being a disinclination on the part of insurers to have their name publicly attached to proceedings.²⁶ However, there is now a respectable body of authority that a general discretion does exist²⁷ and the comments by Anderson J in *Yates* are not binding as leave was refused on other grounds.

23 *David J Reid (NZ) Ltd v CE Health and Casualty and General Insurance (NZ) Ltd* (1992) 7 ANZ Insurance Cases 61-137, 77-709; *National Mutual Fire Insurance Company Limited v The Commonwealth of Australia* (1981) ANZ Insurance Cases 60-438. *Hatea Motors Ltd v Foote* (1992) 7 ANZ Insurance Cases 61-130.

24 Above n 21, 77,307.

25 Above n 8.

26 (1936) 247 NZPD 236-50.

27 Above n 23; See also *Lissenden v Yorkville Nominees Pty Ltd (In Liquidation) & Ors* (1984) 4 ANZ Insurance Cases 60-692 (per Mahoney JA); *FAI (NZ) General Insurance Company Ltd v Blundell & Brown Ltd* [1994] 1 NZLR 11 (per Hardie-Boys J); *Grimson v Aviation and General Underwriting Agents Ltd* (1991) 7 ANZ Insurance Cases 61-095 (per Kirby P).

III DEFENCES AVAILABLE TO THE INSURER UNDER THE CONTRACT OF INSURANCE

The article has already considered the situation where the event giving rise to the claim against the insured is not a risk insured against under the contract of insurance.²⁸ The situation where the event is an insured risk but the insurer is entitled to disclaim liability under the policy is now considered.

A *Pre-event Breach/Pre-event Condition Precedent*

In New South Wales the equivalent provision to s 9(4) contains a proviso, not present in the New Zealand legislation, that leave must not be granted where the insured is entitled to disclaim liability under the policy (the "proviso").²⁹

The effect of this proviso was considered in *Lissenden v Yorkville Nominees Pty Ltd (in Liq) and Ors*.³⁰ The application for leave proceeded by way of an agreed statement of facts; it was common ground that one of the insureds had made a false statement in a proposal and the contract of insurance incorporated the proposal as a term of the policy. The majority of the Court of Appeal and (on a subsequent appeal) the High Court of Australia,³¹ did not consider it necessary to refer to the proviso to refuse the third party leave to issue proceeding against the insurer.

As the judgements of the New South Wales Court of Appeal and the High Court in *Lissenden* demonstrate, the absence of the proviso in the New Zealand legislation is not significant. If the insurer is entitled to avoid the contract of insurance prior to the event giving rise to a claim for damages by the third party then, under s 9(1), no insurance money "becomes payable" and consequently no charge arises.

B *Post-event Breach/Post-event Condition Precedent*

Generally, the insurer's liability to the insured arises either at the time of the event giving rise to a claim by the third party or when the insured lodges a claim with the insurer. Conditions relating to the notification of claims and providing assistance to the insurer after the event are commonly stated in the policy as conditions precedent to the liability of the insurer to the insured. Will a post-event breach or a failure by the insured to fulfil a post-event condition precedent affect either the creation of the charge or its ultimate enforceability?

28 See Part II A of this article.

29 See above, n 2.

30 (1984) 3 ANZ Insurance Cases 60-597 ("*Lissenden*").

31 *Yorkville Nominees Pty Ltd (in liq) & Ors v Lissenden* (1986) 4 ANZ Insurance Cases 60-692.

With the exception of Kirby P in the New South Wales Court of Appeal, the courts accept that the insurer can rely on matters occurring after the event to avoid liability to the third party in respect of the statutory action for enforcement of the charge.³²

A useful summary of the approach adopted by Kirby P is contained in his judgement in *McMillan v Mannix & Anor*³³ In his view, once the event giving rise to a claim for damages against the insured occurs, the third party's rights are determined by the statute and not the contract of insurance. Kirby P accepts that if the insurer is entitled to disclaim liability at the time of the event, then the third party is not entitled to the beneficial operation of the Act.

Where Kirby P differs from the approach taken in other cases is in his view that the third party's statutory rights cannot be denied by matters subsequent to the creation of the charge, even if those matters might have relieved the insurer of its obligations to the insured. In his view the policy of the legislation is to protect the third party, not the insurer or the insured. Conduct or transactions subsequent to the event are not relevant to enforcement of the third party's statutory rights as s 9(1) acts to "freeze" or maintain the status quo at the time that the charge is created.

With respect, that view must be incorrect. If the insurer is entitled to disclaim liability to the insured, then under s 9(1) no insurance money becomes payable to the insured. As the creation of the charge is linked to the event, and not to the contract of insurance, it is submitted that matters occurring after the event will not prevent the creation of the charge, but the enforceability of the charge may be affected by those subsequent events. To hold otherwise would be to create a situation where the insurer is liable to the third party in circumstances where it would not be liable to the insured.

The legislation is not intended to increase the liability of the insurers. As Meagher J said in *McMillan*;³⁴

The purpose is to enable the [third party] to have recourse against funds paid or payable by the [insurer] to the insured) in respect of the injury of which the [third party] complains. It does so by granting a charge over the moneys paid or payable. In this manner it prevents the [insured] from either disbursing the moneys amongst its creditors or frittering it on its own purposes; it also prevents the [insured] and its insurer making a corrupt bargain. But the converse is also true. If there are, absent a corrupt bargain, no moneys payable to the insured,

32 *McMillan v Mannix & Anor* (1993) 7 ANZ Insurance Cases 61-194; *Oswald v Bailey* (1987) 4 ANZ Insurance Cases 60-807; *NSW Medical Defence Union Ltd v Crawford* (No2) (1994) 8 ANZ Insurance Cases 61-226; *David J Reid (NZ) Ltd v C E Heath Casualty and General (NZ) Insurance Ltd* (1992) 7 ANZ Insurance Cases 61-137; *Maaka v State Insurance General Manager* (1989) 5 ANZ Insurance Cases 60-962.

33 (1993) 7 ANZ Insurance Cases 61-194.

34 Above n 33.

there is no right for the [third party] to have a charge over anything or an action against the insurer. ... It was not the purpose of the section to increase the liability of the insurers.

Reference should also be made to Kirby P's comment in *McMillan*³⁵ that his approach to the legislation has been adopted by Thomas J in *Independent Wool Dumpers*. Thomas J approved of Kirby P's analysis of the policy behind the legislation contained in *Oswald v Bailey and Ors; Crawford v Bailey and Ors*.³⁶ That case was concerned with the issue of whether the insurer could, after the event, vary the terms of the contract of insurance and not the issue examined in *McMillan* of whether a breach by the insured would entitle the insurer to avoid liability to the third party. *Independent Wool Dumpers* was concerned with whether the event was an insured risk.

In the author's view, Thomas J's approval of the approach adopted by Kirby P is limited to general support for Kirby P's analysis of policy behind the legislation.³⁷ Thomas J clearly accepts that the insurer should not be liable to the third party in the absence of any liability to the insured:³⁸

I consider that it would be easier to escape the prongs of Morton's fork than it would be for the [third party] to avoid the limitations and exceptions in the policy. ... In all, [the insured] could not arguably sustain a claim for indemnity against [the insurer], and the [third party] standing in [the insured's] shoes is in no better position.

In considering matters occurring subsequent to the event giving rise to a claim for damages against the insured, regard must also be had to whether the third party can invoke the Insurance Law Reform Act 1977. Before examining that issue, it should be noted that, in the author's view, not all conditions precedent to the insurer's liability to the insured will enable the insurer to avoid liability under the statutory action. If the condition in the contract of insurance is not a true condition precedent to the insurer's liability to the insured, but rather a condition precedent to recovery by the insured,³⁹ then it is submitted that the statutory charge will override such a provision.

C *The Insurance Law Reform Act 1977*

In some circumstances the Insurance Law Reform Act 1977 will operate to prevent the insurer from disclaiming liability to the insured. Because the third party does not stand in

35 Above n 33, 78,204.

36 (1987) 4 ANZ Insurance Cases 60-087. (Note: The author has not examined the issue of whether the insurer can unilaterally vary the contract of insurance, as the situations in which this could occur are probably rare.)

37 Above n 11, 77,804.

38 Above n 11, 77,810.

39 See Part V of this article.

the shoes of the insured vis a vis the insurer, there is an argument that the third party cannot rely on the Insurance Law Reform Act 1977 as there is nothing in either the Law Reform Act 1936 or the Insurance Law Reform Act 1977 which specifically enables the third party to rely on the latter Act.

However, the insurer, in establishing that it is entitled to disclaim liability to the insured, would need to have regard both to the terms of the policy and the applicable law. If the remedial provisions of the Insurance Law Reform Act 1977 prevent the insurer from declining liability to the insured, then the insurance money is available to the third party via a statutory action against the insurer.

In *David J Reid (NZ) Ltd v CE Heath Casualty and General Insurance (NZ) Ltd*⁴⁰ the insured failed to give notice and supply particulars of the third party's claim to the insurer. It was assumed that the third party could rely on s 9 of the Insurance Law Reform Act 1977⁴¹ to prevent the insurer disclaiming liability to the insured.⁴² However it was not necessary to decide the issue of prejudice to the insurer under the Insurance Law Reform Act 1977 because the court recognised it had a general discretion to refuse leave under s 9 of the Law Reform Act 1936 in situations where lack of early notice of the claim caused prejudice to the insurer.

Where an insurer declines liability to the insured, the insurance contract frequently imposes a limitation period for the taking of action against the insurer. Does the expiry of the contractual limitation period affect the existence of the charge?

In *Maaka*⁴³ cover was declined because the insured failed to comply with the insurer's request for further information about the claim. The policy further provided that the insurer was not liable under the policy unless the insured took action to enforce the policy within a certain period. The Court of Appeal held that the insured's failure to comply with a condition to take action to enforce the policy within a certain period entitled the insurer to disclaim liability to the insured. There being no liability to indemnify the insured, leave to commence the statutory action was refused.

40 (1992) 7 ANZ Insurance Cases 61-137.

41 Section 9 of the Insurance Law Reform Act 1977 provides that a failure by the insured to comply within time limits for notifying the claim or issuing proceedings against the insurer shall not be a ground for disclaiming liability unless "[I]n the opinion of the court or arbitrator determining the claim the insurer has in the particular circumstances been so prejudiced by the failure of the insured to comply with such a provision that it would be inequitable if such provision were not to bind the insured."

42 The same assumption was made in *Maaka* but the Court of Appeal was not required to consider whether s 9 of the Insurance Law Reform Act 1977 would assist the third party because the claim arose before the inception of that Act.

43 Above n 15.

In this situation, the court could not use its general discretion to grant leave under s 9(4) of the Law Reform Act 1936 because under s 9(1) there is no insurance money payable to the insured. The third party would have to rely on s 9 of the Insurance Law Reform Act 1977 to avoid the operation of a contractual limitation period.

Regard must also be had to whether the third party can invoke s 11 of the Insurance Law Reform Act 1977 to prevent the insurer from relying on non-causative breaches of the policy to decline liability. For s 11 to apply:

- (a) the contract of insurance must exclude or limit the liability of the insurer on the happening of certain events or on the existence of certain circumstances; and
- (b) the Court must find that the happening of such events or circumstances was in the view of the insurer likely to increase the risk of the loss occurring; and
- (c) the insured can prove that the loss in respect of which the insured seeks indemnity was not caused or contributed to by the happening of the event or the existence of such circumstance.

If (a), (b) and (c) are met then the insurer is not entitled to refuse to indemnify the insured. It has been held that conditions precedent relating to notification of claims fulfils requirement (a), but there is a divergence of judicial opinion on requirements (a) and (c).⁴⁴

In *Nupin Distribution Ltd v Harlick*⁴⁵ the insured delayed making the claim, made a false statement to the insurer, and admitted liability to the third party. The insurer denied liability on the grounds of failure by the insured to fulfil three conditions precedent. Wylie J held that requirement (b) was met because an insurer would regard delay, provision of a false statement and an admission of liability as likely to increase the risk of an insured's liability to third parties.

Nupin Distribution Ltd should be contrasted with the position of the Court of Appeal in *Forbes v NZ Insurance Co Ltd*.⁴⁶ In that case a failure by the insured to make a truthful claim did not fulfil requirement (b) because the statement was made after the motor vehicle accident and was therefore not likely to increase the risk of any loss or damage to the motor vehicle. The *Forbes* case concerned first party insurance and it is submitted the position is different in respect of liability insurance where a failure to make a claim or an admission of liability after the event may increase the ultimate liability of the insured (and thereby the insurer) to the third party.

44 *Sampson v Goldstar Insurance Co Ltd* (1980) 1 ANZ Insurance Cases 60-043; *Nupin Distribution Ltd v Harlick* (1988) 5 ANZ Insurance Cases 60-784; *Forbes v NZ Insurance Co Ltd* (1988) 5 ANZ Insurance Cases 60-871.

45 Above n 44.

46 Above n 44.

If the insurer is prejudiced by the failure of the insured to fulfil a condition precedent, then requirement (c) is unlikely to be met. For example, if the insured does not notify the claim to the insurer and allows judgment to be entered against the insured on an admission of liability, then the insurer may argue the risk it has agreed to cover has increased because it has been denied the opportunity to deny liability and defend the claim.

In summary:

- (a) if the insurer is not liable to the insured, then no insurance money becomes payable, and consequently the statutory action to enforce the charge will fail;
- (b) it is likely that the parties to the statutory action can rely on the Insurance Law Reform Act 1977, although in reality there is little difference between the exercise of the court's discretion under s 9 of the Insurance Law Reform Act 1977, and the court's general discretion under s 9 of the Law Reform Act 1936;⁴⁷
- (c) whether s 11 of the Insurance Law Reform Act 1977 applies will depend on the facts in each case, in particular, whether the third party can prove that non-compliance with a condition precedent has not contributed to the loss which the insurer is otherwise required to indemnify.

IV LIMITATION PERIOD ON THE STATUTORY ACTION

Leave to enforce the charge will be refused when delay in bringing the primary action gives rise to a defence that the third party is barred from proceeding further by the Limitation Act 1950. If the primary action is statute barred, s 9(4) enables the insurer to set up any defence to the statutory action which is available as a defence to the primary action. This part of the article considers whether the statutory action is subject to an independent limitation period.

A The Current Position

In *Grimson v Aviation and General (Underwriting) Agents Ltd*,⁴⁸ proceedings had been issued against the insured within the limitation period, but the insured went into liquidation and the third party did not seek leave to issue proceedings against the insurer until after limitation period for the primary action had expired. The majority of the New South Wales Court of Appeal, Kirby P dissenting, held that the limitation period for the enforcement of the charge runs in tandem with the primary cause of action against the insured. This conclusion was reached from an analysis of s 6(4) of the Law Reform Act 1946 (NSW), the material part of which is identical to s 9(4) of the New Zealand legislation.

47 See Part II C of this article.

48 (1991) 7 ANZ Insurance Cases 61-095.

Meagher J (with whom Hope A-JA concurred), interpreted the section as allowing any defence available in the primary action to be raised as a defence to the statutory action. In determining the limitation period on the statutory action the court must ask this question: What would be the third party's position if he or she began proceedings against the insured in the primary action at the date of applying for leave to proceed against the insurer in the statutory action? If at the date of applying for leave the primary action is statute barred, the third party is also barred from proceeding with the statutory action.

However, in *Grimson* the primary action was not statute barred as the proceedings against the insured had been commenced within the limitation period for that action. Nevertheless, Meagher J said the statutory action was statute barred because the statutory action was not commenced within the limitation period for the primary action. Although the section allows the insurer to raise any defence available to the insured, the majority decision in that case effectively allowed the insurer to raise a limitation defence which was not available to the insured.

As leave to commence proceedings against the insurer will not generally be granted while the insured is solvent, if insolvency occurs after the expiry of the limitation period for the primary action, it will then be too late for the third party to enforce the charge. Kirby P, in the dissenting judgment in *Grimson*, held that leave should be granted even though the limitation period for the primary action has passed. His reasoning was that the purpose of the Act, to provide relief in the event of the insured's insolvency, would be too easily frustrated if there was a limitation period on the statutory action.

Kirby P noted that Parliament did not prescribe a specific limitation period on the statutory action.⁴⁹ He construed the proviso in the section as providing a general discretion to grant leave, with prejudice to the insurer arising from delay in bringing the statutory action being one factor to consider. Although there had been gross delay in pursuing the statutory action, the insurer did not suffer any prejudice through lack of notice of the claim because it had earlier been joined as a third party to the primary action. Accordingly, in his view, leave should be granted.

Prior to *Grimson*, the limitation period on the statutory action had been considered by two inferior New South Wales courts.⁵⁰ Both cases adopted the view that the limitation period on the statutory action runs in tandem with the primary action.

49 Above n 48, 77,386.

50 *Cambridge Credit Corp Ltd v Lissenden* (1987) 4 ANZ Insurance Cases 60-776; *Ratcliffe v VS & B Border Homes Ltd* (1987) 4 ANZ Insurance Cases 60-789.

The expiry of the statutory limitation period in the primary action in *Maaka*⁵¹ was not raised by the insurer as a grounds for refusing leave to proceed with the statutory action. Although the Court of Appeal was not required to decide the point, it did note, without expressing a view, the decision of the New South Wales Supreme Court in *Cambridge Credit Corp v Lissenden*.⁵² The Court of Appeal in *Maaka* was concerned with a limitation period imposed by the contract of insurance.⁵³

In *Hatea Motors Ltd v Foote*⁵⁴ it was accepted by the parties (without any argument or reference to the Australian cases) that the limitation period on the statutory action was the same as the limitation period on the primary action. The argument in that case focused on whether proceedings in respect of the statutory action commenced when the application for leave was filed or when leave was in fact granted. The court held that the statutory action was within the limitation period if a statement of claim against the insurer was filed with the application for leave. The court was not referred to the Court of Appeal's obiter comment in *Maaka*,⁵⁵ where it was said that it was not sufficient for the application for leave to be filed prior to the expiry of the limitation period; leave must be granted and proceedings to enforce the charge issued prior to the expiry of the limitation period in the primary action.

Heron J in the High Court hearing of *FAI*⁵⁶ considered that the limitation period on the statutory action would commence only when the insurer declined the insured's claim under the policy. In his view, the third party was subject to the same limitation period as the insured in terms of an action against the insurer. Although this approach achieves the right result from the third party's perspective, it assumes that the third party stands in the shoes of the insured. As previously discussed,⁵⁷ the insurer has the same rights as the insured in respect of the primary action. However, the converse is not true; the third party does not necessarily have the same rights to enforce the insurance policy as that held by the insured.

Limitation issues arose for consideration in *FAI*⁵⁸ where the Court of Appeal accepted that the limitation period for the statutory action runs in tandem with the primary action. In

51 Above n 15.

52 Above n 50.

53 See Part III B of this article.

54 Above n 23.

55 Above n 15, 76,165.

56 (1993) 7 ANZ Insurance Cases 62-183.

57 See Part I of this article.

58 Above n 18.

FAI the primary action against the insured, being an action in equity seeking an account of profits arising out of a breach of a fiduciary duty, had no limitation period. Applying s 9(4), the Court of Appeal treated the statutory action as having the same limitation period as the primary action; the insured could not have relied on a statutory limitation period, and the insurer was in no better position.

In *FAI* the court was not required to consider the situation in which the primary action is subject to a limitation period and proceedings against the insured have been issued within the limitation period, *but* leave has not been sought to pursue the statutory action within the limitation period of the primary action. However, just such circumstances did recently come before the High Court in *UEB Packaging v QBE Insurance*⁵⁹ where Baragwanath J expressed strong support for the majority view in *Grimson*, saying that unless the statutory cause of action by the plaintiff against the insurer shadows the cause of action against the insured, the clear language of the section is departed from.⁶⁰

These approaches, as well as an argument that the statutory action is subject to its own limitation period under the Limitation Act 1950, are considered next.

B What Limitation Period should apply?

The author considers that the majority in *Grimson* was incorrect in finding that the section imposed a limitation period on the statutory action against the insurer. If the third party fails to commence the primary action within the applicable limitation period, then the section enables the insurer to raise that as a defence to the statutory action; that is, the section allows the insurer to rely on any limitation defence that was open to the insured. To that extent *FAI* and *Grimson* were correctly decided.

However, *Grimson* goes further and allows the insurer to raise a limitation defence which would not have been available to the insured. Richardson J in *FAI*, refers to the majority approach in *Grimson* and seems to accept that the limitation period for the statutory action runs in tandem with the limitation period for the primary action. Robertson J does not express a view on this point. Hardie-Boys J considered that for limitation purposes, time would cease to run on the statutory action upon the commencement of the primary action against the insured. The basis for his reasoning being that the section places the insurer in the same position as the insured.

Like Kirby P in *Grimson*, Hardie-Boys J also considered that there was a general discretion to refuse leave in circumstances where the insurer is prejudiced by a late

59 [1996] 2 NZLR 467.

60 Above n 59, 481. See also *Bailey v NSW MDU Ltd; NSW MDU Ltd v Crawford* (1995) 8 ANZ Insurance Cases 61-291, which Baragwanath J cites with approval.

application for leave to enforce the charge. In terms of balancing the interests of the parties, the approach of Kirby P and Hardie-Boys J achieves the right result by avoiding hardship to the third party and preventing a potential windfall to the insurer. The author accepts that a general discretion exists, but submits that there is a limitation period on the statutory action which exists independently of the limitation period on the primary action.

It was argued in *FAI* that action to recover the insurance money subject to the charge was an independent cause of action created by statute; and therefore it was subject to a limitation period of six years.⁶¹ Richardson J rejected this argument finding that s 9 "[I]s a procedural provision ... It merely makes available to the claimant a more effective procedure for enforcing rights." That view must be incorrect as, except for s 9, there is no common law or statutory right to issue proceedings against the insurer to recover money due under the contract of insurance. Richardson J supports his conclusion with the observation that the section puts the insurer in the same position as the insured for the purposes of the primary action and the third party "should be in no better or worse position if seeking to proceed against the insurer than if proceeding against the insured."⁶²

The section deals with defences to the primary action. It does not impose a limitation period on the statutory action. If the primary action against the insured is not issued within the limitation period for that action, that is a defence available to the insurer in the statutory action. The source of the third party's rights against the insurer are statutory, and the limitation period on the statutory action must be prescribed by statute if one is to apply at all.

In the author's view, the statutory cause of action created by s 9 is "an action to recover a sum due under an enactment" and a limitation period of six years from the date of the event applies under s 4(1)(d) of the Limitation Act 1950.⁶³

On this analysis, a limitation defence can be raised by the insurer if six years elapse between the event giving rise to a claim against the insured and the commencement of the statutory action against the insurer. To avoid limitation problems the third party would be required to seek leave to commence the statutory action prior to the expiry of the six year period, even if the insured was not, at that time, insolvent.

An alternative approach, and one that causes less hardship to the third party, is to recognise that the charge is in the nature of a security. An action to enforce the charge, like

61 Limitation Act 1950, s 4(1)(d).

62 Above n 18, 17.

63 See, for example, the application of s 4(1)(d) of the Limitation Act 1950 to statutory misfeasance proceedings against directors under the Companies Act 1955, s 320; *Re: Network Agencies Ltd* [1992] 3 NZLR 325.

any other security, would not be subject to any limitation period, but would be enforceable at the suit of the chargeholder. The insurer's position could be protected by the exercise of the court's general discretion to refuse leave in circumstances where the insurer is prejudiced by lack of notice of the claim. The difficulty with this approach is that the charge is created by statute, therefore the third party should look to statute to find the means for enforcing the charge. As s 9 is silent as to the limitation period on the statutory action, the better view is that s 4(1)(d) of the Limitation Act 1950 imposes a limitation period on the statutory action.

Whether New Zealand courts continue to favour the approach adopted by the majority in *Grimson*, or the six year limitation period imposed by s 4(1)(d) of Limitation Act 1950, the result is unsatisfactory from the third party's perspective. The third party is generally unable to issue proceedings against the insurer while the insured is solvent. There is a real risk, therefore, that the limitation period on the statutory action will expire before the third party has an opportunity to enforce the charge.

If s 9 is to be retained, then the section should be amended to clarify the position on whether the statutory cause of action is subject to an independent limitation period. In the author's view, provided the primary action is commenced in time, there should not be any limitation period on the statutory action. The insurer's position could be protected by the exercise of the court's general discretion to refuse leave in circumstances where delay in bringing the statutory action causes prejudice to the insurer.

This was the approach favoured by Kirby P in *Grimson* and Hardie-Boys in *FAI*. It achieves the right result by avoiding hardship to the third party and preventing a potential windfall to the insurer. However, the author believes that s 9(4) does not achieve this result and amendment to the legislation is required.⁶⁴

V CONDITIONS PRECEDENT TO RECOVERY BY THE INSURED

This article has previously considered situations where a breach of the contract of insurance or a failure by the insured to fulfil a condition precedent enables the insurer to avoid liability under the contract of insurance.⁶⁵ The contract of insurance usually requires proof of loss before the insurer is required to make payment to the insured. Proof of loss is normally established by the third party's judgment against the insured, settlement of the claim, or payment to the third party (conditions precedent to recovery by the insured).

64 This view is clearly shared by Justice R D Giles, the Chief Judge of the Commercial Division, Supreme Court of NSW in his recent article on s 6 of the Law Reform (Miscellaneous Provisions) Act 1946 in (1995) 7 ILJ 152.

65 Part III of this article.

Obviously, these conditions frustrate the purpose of s 9 in situations where the insured is insolvent. The article examines two conditions precedent to recovery by the insured with a view to establishing that s 9 can override a specific contractual provision.

A Requirement of a Prior Judgment against the Insured

Section 9(5) makes it clear that the statutory action can proceed even if the third party has judgment against the insured. What is the position where the contract of insurance requires a judgment against the insured as a condition precedent to recovery by the insured? This issue was considered in an English case where it was held the third party could not commence an action against the insurer in the absence of a prior judgment against the insured.⁶⁶

The position may be different in New Zealand, where the third party's rights are determined by the statute and not the contract of insurance. The charge can, if permitted by s 9, override the express provisions of the contract. Subsection (1) makes it clear that the charge arises notwithstanding that the amount of the insured's liability has yet to be determined. Subsection (4) expressly contemplates that action may be taken against the insurer in the first instance and impliedly contemplates that the charge will be enforceable directly against the insurer in the absence of prior judgment against the insured. It is implicit in subs (5) that judgment against the insured is not a pre-condition to the enforcement of the charge. Thus there is evidence of legislative intent for the charge to be enforceable against the insurer notwithstanding that there is no judgment against the insured.

However, there is argument to the contrary. Subsection 9(1) provides for a charge to arise over the insurance money payable under "a contract of insurance by which he [the insured] is indemnified against liability to pay damages". How can it be said that the insured is indemnified under the insurance policy when that policy expressly provides that there is no indemnity until the insured's liability has been determined? Subsection (1) provides for the charge to arise notwithstanding that the quantum of the insured's liability to the third party has yet been determined. It does not provide that the charge will arise notwithstanding that the insured's liability to the third party has yet to be determined.

This issue has not arisen in any of the Australian or New Zealand decisions. If the issue arose, it is likely that the courts will try to avoid any construction that requires the third party to obtain judgment or establish the insured's liability before the charge is enforceable against the insurer.

There is no reason, in principle, why there should be a requirement to establish the insured's liability prior to pursuing the insurer. If the third party is required to establish

66 *Post Office v Norwich Union Fire Insurance Society Ltd* [1967] 2 QB 363; [1967] 1 All ER 577 (CA).

the insured's liability in the primary action before the charge is enforceable, this could be achieved by joining the insurer to the primary action and running the statutory action in tandem with it. In the author's view, this situation is contemplated by s 9(4).

B "Pay and be Paid" Clauses

There is House of Lords authority⁶⁷ that the third party has no claim against the insurer where the contract of insurance places an obligation on the insured to pay the amount of the claim to the third party before seeking reimbursement from the insurer. This issue has arisen in the context of "pay and be paid" clauses in insurance policies where the insurer has no liability unless and until the insured had met the liability owed to the third party.

A similar issue was discussed in *Independent Wool Dumpers*, where Thomas J said:⁶⁸

The contingent nature of the cover is confirmed by the terms of condition 10 of the policy. It reads as follows:

"Liability of the Company under this policy with respect to any occurrence shall not attach unless and until the Insured, or the Insured's underlying insurer, *shall have paid the amount* of underlying limits on account of such occurrence... "

Stressing that this condition was couched in absolute terms, Ms Courtney argued for AIU that no cover exists under the umbrella policy until the underlying insurer has actually paid the amount of the underlying limit. While this interpretation is correct in terms of the policy, I do not accept that it prevails so as to defer the statutory charge attaching to the insurance money which is or may become payable pursuant to section 9 until the claims against the underlying insurers have been pursued to completion. The fact that any such claim may not have been exhausted simply means that the amount of the insured's liability has not been determined. Section 9 expressly contemplates such a situation. To hold otherwise would be to defeat the purpose of the section.

With respect, there is nothing in s 9 which expressly allows the charge to over-ride the specific contractual agreement between the insurer and the insured. The words "notwithstanding that the amount of such liability may not have been determined" refer to an intent for the charge to arise notwithstanding that the *amount* of the insured's liability to the third party has yet to be settled by agreement or judgment. It does not refer to an intention for the charge to be enforceable against the insurer regardless of whether the *insurer's liability to the insured* is established.

67 *The Fanti, The Padre Island*. [1990] 2 Lloyd's Law Rep 191 (HL).

68 (1993) 7 ANZ Insurance Cases 61-152, 77,806. (emphasis added) The case was decided on other grounds, so the comments do not form part of the ratio of the decision.

It is apparent that "pay and be paid" clauses defeat the purpose of the legislation in that the charge is only enforceable after the insured has met the claim of the third party. The purpose of the legislation is not to create a windfall to the insurer in the event of the insured's insolvency. In the author's view s 9 over-rides any conditions precedent to recovery by the insured which avoid the operation of the charge created by the legislation. Alternatively, the third party may be able to rely on the operation of s 11 of the Insurance Law Reform Act 1977 to prevent the insurer disclaiming liability under a "pay and be paid" clause.⁶⁹

VI "CLAIMS MADE AND NOTIFIED" POLICIES

Under a "claims made and notified" policy, the insurer agrees to indemnify the insured for claims made during the currency of the policy, regardless of when the event giving rise to the claim occurs. Thus the situation can arise where the event giving rise to a claim for damages occurs at a time when there is no insurance policy in force. How can a charge attach to something which is not yet in existence?

This issue was considered in *Manettas*,⁷⁰ where it was held, applying a provision identical to s 9(1), that the charge must attach at the time of the event giving rise to a claim for damages. If there is no insurance policy in existence at that time, there can be no insurance money capable of being charged. Cole J stated:⁷¹

If at the time [of the event] there is no policy there cannot be any insurance moneys "that are or may become payable" in respect of that liability under any then existing policy. The section does not say that a charge affixes in respect of insurance moneys which "are or may become payable" under insurance policies which may be written in the future.

Cole J rejected the argument that the remedial purpose of the legislation should ensure that the section was not interpreted in a narrow or pedantic way. Cole J was of the view that the court is bound by the words used by the legislature where they are as clear as those set out in s 9(1).⁷²

The earliest reference the author has found to "claims made" policies is in an English text published in 1968⁷³ and it appears that liability insurance, let alone of the "claims made" variety, was not commonly available in 1936. As a matter of statutory interpretation, if

69 See Part III C of this article.

70 Above n 17.

71 Above n 17, 78,032.

72 This issue was further considered in *Schipp v Cameron* (Unreported, 4 May 1995, Supreme Court NSW) where Young J differed with Cole J's approach and held that the section does apply to "claims made" policies.

73 P Madge *Professional Indemnity Insurance* (Butterworths, London, 1968) 42.

"claims made" policies were not contemplated by the legislature in 1936, the section can only apply if the wording of the statute permits it.⁷⁴

The application of s 9 to "claims made" policies has yet to be fully considered in New Zealand. The Court of Appeal in *FAI* reached the view that s 9 does apply to "claims made" policies, but it is not apparent from the decision whether or not the Court had the benefit of any argument on the issue.

It was acknowledged that s 9 does not advert to situations where the contract of insurance comes into existence after the event giving rise to the third party's claim.⁷⁵ Richardson J considered that it was implicit in s 9(1) "and in accord with reality that the charge cannot arise unless and until there is insurance money available out of which it can be met".⁷⁶ Without any further analysis, Richardson J concluded that the charge arose at the time the insured entered into a "claims made" policy with the insurer.

That conclusion conflicts with the clear legislative intent expressed in s 9(1) that the charge arises on the happening of the event. Even Richardson J acknowledged, earlier in his judgment, that that charge arose on the happening of the event.⁷⁷ If there is no insurance policy in existence at the time of the event there is no insurance money upon which the charge can "bite".

Hardie Boys J dealt with the issue in a slightly different way. Instead of looking at the timing of the creation of the charge, he considered that the charge arose at the time of the event but was conditional upon the insurer's liability being established. In the author's view, the charge is conditional in the sense that the charge is not enforceable until the insurer's liability to indemnify the insured is established. However, there is nothing in s 9(1) to suggest that the creation of the charge itself is conditional on some later occurrence.

If there is no insurance policy in existence at the time of the event, then no charge is created. With respect, it is not open to the court to ignore the clear wording of a statute to ensure it accords with developments which have occurred subsequent to the enactment of the legislation. Even if the legislature had contemplated "claims made" policies in 1936, there is nothing in the section that would allow the court to construe the charge as being capable of arising at some time later than the happening of the event.

The section creates a fictional charge over the insurance money before the insurer has accepted liability for the claim; there is no difference in principle between this, and the

74 J F Burrows *Statute Law in New Zealand* (Butterworths, Wellington, 1992) 175-176.

75 Above n 18, 16 (Richardson J), 25 (Robertson J).

76 Above n 18, 16.

77 Above n 18.

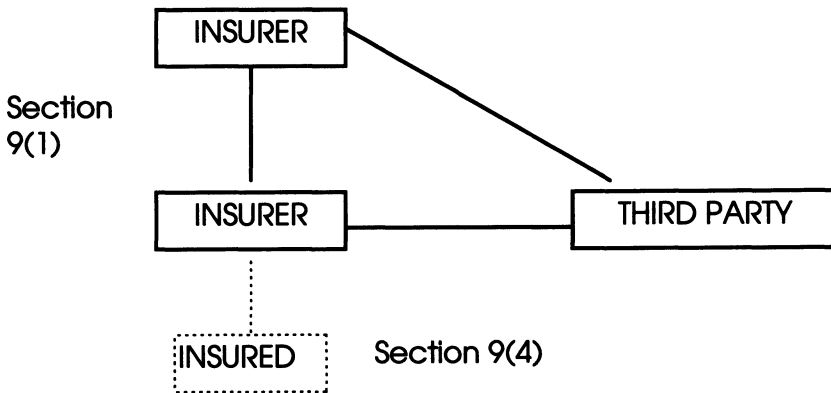
charge attaching to an insurance policy that has yet to come into existence. In other words, if the charge can attach to non-existent insurance money, there is no reason, in principle, why it should not attach to a non-existent policy. While this argument is attractive, it ignores the requirement that a contract of insurance must be in existence at the time of the event.

The position would be different if s 9 created an assignment of the insured's rights under the contract of insurance to the third party, as is the case in the English legislation.⁷⁸ Under English legislation, the assignment occurs when the insured becomes insolvent and not upon the event giving rise to a claim for damages against the insured. Thus a "claims made" policy would be in existence at the time that statutory rights are conferred on the third party.

In the author's view, "claims made" policies are not subject to the application of the Law Reform Act 1936. It may be that this significantly frustrates the purpose of the Act but the clear wording of the Act does not permit any other interpretation. Nevertheless it is likely that the court will strive hard to find an interpretation to the Act which keeps it up to date with the development of "claims made" policies.

VII SUMMARY

At this stage it is appropriate to refer back to the introductory discussion on the legal relationship between the insurer and the insured. Having considered the impact of s 9 on the triangular relationship between the parties, the original diagram can now be represented to more fully describe the relationship between the parties.



78 Third Parties (Rights Against Insurers) Act 1930 (UK).

Upon commencement of insolvency, the insured drops out enabling the insurer to stand in the shoes of the insured in relation to defence of the primary action (s 9(4)). Unless the insured is insolvent at the time of the event, the third party requires leave to enforce the charge. In determining whether leave should be granted the court has a general discretion to refuse leave in circumstances where the insurer is prejudiced by delay in the application for leave to enforce the charge.

Where the insurer is entitled to avoid the contract of insurance then under s 9(1) there is no insurance money payable, and consequently nothing upon which the charge can attach. With the exception of Kirby P in the New South Wales Court of Appeal, the authorities accept that the insurer can rely on the matters occurring subsequent to the event to disclaim liability to the insured. The cases are correct in this approach as the legislation was not intended to increase the liability of insurers.

However, in the author's view, a distinction can be made between conditions precedent to the insurer's liability and conditions relating to proof of loss. If the contract of insurance requires the insured to establish liability to the third party or meet the third party's claim prior to the inception of the insurer's liability, then the purpose of s 9 is clearly defeated.

Section 9(1) makes it clear that the charge arises notwithstanding that the quantum of the third party's claim has yet to be determined. Parliament could not have intended to create a charge in favour of the third party only to allow the insurer prevent the enforcement of the charge by the third party. In the author's view, conditions precedent to recovery by the insured do not operate to defeat the enforcement of charge, as proof of loss can be established by the third party in the statutory action.

It has yet to be established whether the statutory action is subject to its own limitation period. Section 9(4) makes it clear that where the third party fails to commence the primary action within the limitation period for that action, the insurer can rely on that as a defence to the statutory action. More problematic is the situation where the primary action is commenced in time but the statutory action is commenced outside the limitation period for the primary action.

In the author's view, s 9 is silent as to a limitation period on the statutory action. If s 9 is to be retained, then the legislation needs to be amended to clarify whether the statutory action is subject of an independent limitation period. In the absence of amending legislation, it is the author's view that s 4(1)(d) of the Limitation Act 1950 imposes a six year limitation period on the statutory action.

The application of s 9 to "claims made" policies has yet to be fully considered. In the author's view, these policies are not subject to the operation of the Law Reform Act 1936. Although this significantly frustrates the purpose of the Act, s 9(1) clearly pre-supposes

that a contract of insurance will be in existence at the time of the event giving rise to a claim for damages by the third party.

