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Financial Markets Policy
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SUMBISSION ON EXPOSURE DRAFT INSURANCE CONTRACTS BILL

Introduction

1. This submission is addressed to Subpart 4 of Part 3 of the Bill which proposes to repeal of s 9 of the Law Reform Act 1936. Section 9 has not been amended since its enactment in 1936.

2. It is submitted that the proposed repeal and replacement of s 9 will have unintended and undesired consequences.

Purpose of section 9

3. Section 9 is a rare provision in the law because it addresses an injustice that arose at common law upon the insolvency of an insured. In the early 1900s, an innocent third party who suffered a wrong committed by an insured had no priority over insurance proceeds in the event of the insured's insolvency. The issue is exemplified by a case[1] where a pedestrian who was injured by a negligently driven taxi obtained a judgment for compensatory damages against the taxi company (which was insolvent) after the taxi company's insurer paid out insurance funds to the liquidator. By making the payment to the liquidator the insurer discharged their obligation under the policy, but the plaintiff had no right to the insurance proceeds (which were distributed to the insured's creditors in accordance with normal insolvency principles).

4. Section 9 provides an elegant solution to this injustice by creating a "charge" over insurance monies for the benefit of third-party claimants. That charge does not fix the amount of the insurer's liability (that amount remains to be determined by reference to the terms of the relevant insurance contract), but as Johnson J said in *National Insurance Co of New Zealand Ltd v Wilson* [1941] NZLR 639 at 644, s 9 imposes "*on the insurer an obligation to keep intact the amount of its liability to the insured, whatever it may be, so that the injured man is protected*".

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1 *Re Harrington Motor Co Ltd, ex parte Chaplin* [1928] Ch 105 (CA).

5. Due to New Zealand's Accident Compensation legislation, s 9 does not apply to cases involving physical injuries.

6. However, to this day, s 9 provides important protections to victims who have suffered economic losses caused by insureds (for example, the owners of defective properties).

7. Section 9(1) of the Law Reform Act 1936 provides that the charge comes into existence "*on the happening of the event giving rise to the claim for damages or compensation*". This is highly advantageous and enlightened drafting. An injured third party obtains the benefit of the charge from the date the insured wrongs them.

8. Further, s 9(3) says "*Every charge created by this section shall have priority over all other charges affecting the said insurance moneys*". This makes it clear that Parliament intended the insurance monies that are subject to the charge will end up in the hands of the injured third party as opposed to, say, the insured's secured creditors – most likely banks or other lenders.

Proposed amendment

9. Subpart 4 of Part 3 of the Bill proposes to allow a third party who has been wronged by a policyholder to claim directly against the policyholder's insurer.

10. However, this proposal is no improvement on the existing legislation, and it would represent be a worse outcome for injured third parties than the status quo. The main issue is that the proposed reform is that it takes the existing effectively proprietary protection (the s 9 charge) and downgrades it to a weaker and untested ability to sue, in legislation that is less straightforward.

11. In the Consultation Paper - Exposure draft Insurance Contracts Bill dated 24 February 2022 (Consultation Paper) MBIE states that "*There are multiple issues with how the statutory charge operates, including whether costs are to be paid out to policyholders to defend a claim, as well as other timing and priority issues when there are multiple statutory charges*". However, it is respectfully submitted that this summary overstates the problem and that:

    (a) The issue about whether defence costs are to be advanced to policy holders has now practically resolved itself. Insurers were surprised by the decision of the Supreme Court in *Steigrad*[2], but they have now adapted to that decision. For the past 9 years insurers have specified separate limits for insurance and defence costs. This is a good thing as it provides clarity/certainty; and

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2 *FSL 2007 Ltd & Ors (In Liquidation) v Steigrad - [2013] NZSC 156*

(b) While timing and priority issues do arise when multiple claims arise (as these generate multiple statutory charges) this is only an issue in difficult situations. Furthermore, the proposed changes do nothing to simplify or change the law on these points.

Law Commission Report

12. In the 1998 Law Commission Report (R46) *Some Insurance Law Problems*, the Law Commission addressed to academic commentary and asked whether it is proper that a third party continues in effect to be granted priority over other creditors in the insured's insolvency?

13. The answer to the above question, it is submitted, is – obviously yes. As the Law Commission noted, there is a widespread community expectation that a third party's loss will be met from insurance moneys available to the insured. The s 9 charge facilitates that community expectation.

14. The Law Commission in 1998 then went on to ask, if a third party is to be granted an effective priority, then by what general technique should this purpose be achieved?

15. The Law Commission asserted "*complicating property connotations*" with s 9 and went on to say that a charge may theoretically (if not to date in practice) be open to attack under the voidable preference or transaction provisions in ss 56-57 of the Insolvency Act 1967, or the voidable security/charge provisions in ss 292/293 of the Companies Act 1993. This is, however, an abtruse and effectively imaginary objection to s 9 given that the whole point of the charge is to protect the third party, and that a statutory charge over money by the operation of law does not well lend itself to attack.

16. The Law Commission Report went on to ask (as if it was a difficult question) whether an insurer may raise in response to a third parties' action to enforce an s 9 charge, any defence it would have had to an action by the insured to enforce the contract of insurance. The answer to this is obviously yes.

17. The Law Commission Report then went on to recommend repeal of the s 9 charge and its replacement with a provision deeming the benefit of the contract of liability insurance to be recoverable by an injured third party under s 4 of the Contracts (Privity) Act 1982. Sensibly, that recommendation was ignored and s 9 remained in place for a further 24 years from the date of that report.

Comments on current draft

18. This brings us to the current draft of subpart 4, where draft ss 83 to 93 are proposed instead of the existing legislation. Some brief comments follow:

(a) Proposed s 83: This definitions section is painful as it is about as long the original s 9. Apart from its length it is largely unobjectionable as it merely provides definitions. However, "Insured" is a standard term that is well understood in the Insurance industry, and it is much more elegant (and less plain English drafting) than "*specified policy holder*";

(b) Proposed s 84: In effect this confirms that an innocent third party may sue an insurer and that an insurers liability is determined by the contract of insurance between the insurer and insured. These are points that are so obvious that they go without saying;

(c) Proposed s 85: The leave requirement. This appears to be functionally identical in effect to s9(4);

(d) Proposed s 86: This is the proposed replacement for s 9. It is horrible doctrinally as the insurer did not wrong the third party. I am not even sure how to describe the mechanism s 86 uses. It is best described as a fiction. But the fiction is incomplete, and is also bizarrely colloquial (stating that the insurer stands in the place of the insured). However, this is not good enough as there is nothing to say that the actions of the insured are the actions of the insurer. Without this further clarification, a third party could sue an insurer but the insurer could never be liable. Secondly, there is an argument that subsection (2) fails in its purpose entirely as it does not expressly state that a Court has jurisdiction to award a judgment against the insurer;

(e) Proposed s 87: Subsection (1) goes without saying. Subsection (2) is a new innovation that requires further consideration. Insurers' views on this point should be specifically sought, as the proposed wording departs from freedom of contract and the principles of the common law;

(f) Proposed s 88: The wording of subsection (2) appears to result in a bizarre scenario where insurers are unable to raise limitation defences. This scenario could result in claims being brought indefinitely after the event. This is undesirable as it brings the law into disrepute;

(g) Proposed s 89: No comment;

(h) Proposed s 90: No comment;

(i) Proposed s 91: No comment;

(j) Proposed s 92: It is also difficult to understand why the draft Bill excludes reinsurance. The effect of doing so may be to reintroduce the early 1900s common law position whenever current day reinsurance is in play. This could occur if an insured had primary cover to an agreed dollar figure $X, and a secondary layer of reinsurance covered for losses beyond $X. Potentially, large injustices could arise from exclusion of reinsurance and there is no obvious need for this carve out; and

(k) Proposed s 93: I do not have time to comment on Schedule 3 at this stage other than to note that it is an interesting and potentially helpful reform that could be enacted with modifications as necessary to allow it to operate alongside the existing s 9 wording.

19. Overall, the above comments indicate that the current proposed Bill is no improvement on the existing, simpler, and superior legislation.

20. In summary, the “charge” in s 9 has been a feature of New Zealand law for 86 years. The main effect of the charge is to ensure that the insurance funds are kept separate from the pool of assets that is available to an insolvent insured’s creditors.

21. Section 9 is the subject of a wealth of settled law and it is a simple, clean, easy to understand excellent feature of legislation. It deals with some difficult concepts with admirable economy. Although potentially some legal academics may not like the s 9 charge (for their own reasons), s 9 works very well in practice and there are few issues with it.

22. The proposed reforms in Part 3 subpart 4 of the draft for consultation are lacking when compared to the superior protection provided to innocent third party tort victims by s 9 of the Law Reform Act 1936. Therefore, it is submitted that the wording of s 9 ought to be brought forward unchanged into any future consolidating legislation.