By Emma Reilly

# PROFESSIONAL INDEMNITY insurance

## Exposure for insurance brokers and the *Katherine Floods* case


**This article provides an outline of the principles and scope of professional indemnity insurance generally, before describing common issues for brokers giving rise to claims. The article then discusses the *Katherine Floods* decision[1] before providing some suggestions as to what to do if a claim is made.**

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### PROFESSIONAL INDEMNITY INSURANCE

Professional indemnity insurance policies arose out of the need for insurance to cover pure economic loss which was not otherwise covered by public liability policies. By entering into a professional indemnity insurance contract, an insurer promises to indemnify an insured against financial loss suffered as a result of the happening of a risk. The risks that are covered by professional indemnity insurance policies include professional negligence, directors' and officers' liability and medical negligence.

A major distinction between a professional indemnity policy and a public liability policy is that professional indemnity policies are usually '*claims made and notified*' policies, as opposed to '*occurrence*' policies. >>

With an 'occurrence' policy, the insurer's promise to pay is triggered by the happening of an occurrence or loss during the policy period. It does not matter whether the occurrence or loss is made known to the insurer during the policy period, for indemnity to extend. It is the date of the event or occurrence that is relevant to a determination on indemnity.

With a 'claims made' policy, the insurer's promise to pay is triggered by a claim against the insured during the policy period, even if the act or omission of the insured giving rise to the liability occurred before the policy inception. Having said this, there will usually be a '*retroactive*' date in the policy, such that the insurer will not be liable in respect of events prior to that date.

The deductible may also be costs-inclusive or costs-exclusive. There can be an aggregation clause in the policy, providing that related wrongful acts will be treated as a single wrongful act.

A 'claims made and notified' policy covers only a claim made against the insured and notified to the insurer during the policy period. This is subject to s40(3) of the *Insurance Contracts Act* 1984 (Cth), which provides that if the insured has given the insurer details of the circumstances of the claim as soon as possible after becoming aware of the facts and before the policy expires, the insurer is not relieved of liability for the claim, even if it is made after expiry of the policy.[2]

Section 54 of the *Insurance Contracts Act* prevents an insurer from avoiding a contract of insurance due to the insured's breach of policy conditions in certain circumstances. If a contract of insurance has a '*deeming provision*', s54 may create a liability to indemnify even where a claim was made after the policy period has elapsed. The deeming provision will cause such a claim to be deemed to be made within the policy period if the claim circumstances are notified to the insurer within the policy period, similar to the operation of s40. Section 54(1) may save the insured from a fatal policy breach, if they were aware of the claim circumstances and omitted to notify the insurer.[3] These statutory exceptions at least require that the insured is aware of the claim circumstances prior to the expiration of the policy. Where the insured is not so aware, it will be the subsequent policy, if any, that applies.

Professional indemnity policies are claims-made policies rather than occurrence policies to assist insurers with certainty. This is in the context that damage, loss and claims can be significantly latent in the context of professional negligence. With a claims-made policy, the insurer should be aware of all potential claims that it is exposed to by the end of the policy period.

Claims-made policies contain exclusions for liability for claims arising out of circumstances known to the insured at the time that they purchased the insurance policy, if the insured knows, or a reasonable person in the insured's position would have realised, that the circumstances might give rise to a claim. From the insurer's point of view, the insured should have notified that claim to the previous insurer. An interesting decision in that regard is *CGU Insurance Ltd v Porthouse*,[4] involving a barrister and his knowledge of his negligence.

Professional indemnity policies may be costs-inclusive, or costs-exclusive. There is generally a relatively significant applicable deductible. The deductible may also be costs-inclusive or costs-exclusive. There can be an aggregation clause in the policy, providing that related wrongful acts will be treated as a single wrongful act.

Most of the case law in respect of the characterisation of professional indemnity claims stems from public liability insurers arguing that the professional indemnity exclusion in their policy applies. An example of such an exclusion is as follows: '[We will not pay sums arising from:] any breach of duty owed in a professional capacity by you and/or any persons for whose breaches you may be held legally liable.'

It was previously thought that professional indemnity claims arose out of liability incurred in the context of the professions. However, Kirby P in *GIO General Ltd v Newcastle City Council* [5] referred to '*professional*' as meaning no more than advice and services of a skilful character. That case concerned whether the Council was liable in respect of the collapse of the Workers' Club in Newcastle following the earthquake, due to the approval of the buildings.[6]

## ISSUES FOR BROKERS

Once it has been established that indemnity extends, the next issue involves a legal liability resulting from professional negligence. Insurance brokers can be subject to claims including claims for damages for negligence, breach of contract and/or breach of statutory duty – for instance, misleading and deceptive conduct.

It will almost always be the case that a broker will act on the basis of a written or oral contract with an insured, in which case the primary action will arise in contract. A breach of contract may also give rise to concurrent liabilities in negligence and under statute. A claimant is free to pursue whichever cause of action delivers the most likely or advantageous result. Causes of action can be brought in the alternative.

A claim in contract might be more attractive even where there is evidence of negligence, since damages for breach of contract cannot be reduced for contributory negligence. On the other hand, a claim in negligence may be more attractive where the limitation period is an issue, because the time

will run from the date of loss as opposed to the date of the breach of contract, which may have occurred several years prior to any loss. There can also be issues with privity of contract where an insured uses a broker who uses a placing broker – for instance, in relation to insurance placed into the London market. The duty of care owed by sub-brokers is considered in the English High Court decision of *BP plc v Aon Ltd & Aon Risk Services of Texas Incorporated*.[7]

The standard of care required of an insurance broker is the exercise of reasonable skill and care in the performance of his or her obligations. A broker is obliged to:

- follow instructions and make reasonable enquiries;
- arrange and maintain appropriate and effective cover;
- choose a solvent and reputable insurer;
- go through policy exceptions and obligations with the insured; and
- raise usual legal issues that arise in the course of effecting cover, including the insured's duties to disclose material facts and to give notice of claims.

Section 71(1) of the *Insurance Contracts Act* 1984 (Cth) expressly relieves an insurer of its obligations to notify an insured of matters including the duty of disclosure, where a broker is involved.

In summary, a broker's duty is to use their best efforts to obtain and maintain or renew required insurance, and to report any inability to do so to the client. The duty may vary in particular factual circumstances, depending upon:

- whether the client gave very specific instructions, or just wanted general advice;
- whether the scope of advice provided was effectively limited by the broker – for instance, with a disclaimer type statement;
- the client's experience in business and insurance matters; and
- disclosures made by the client.

Issues that regularly arise in broker cases include the extent of the scope of the broker's retainer and the question as to whether the person or entity would have taken out the insurance, even if advised properly by the broker.

In order to protect themselves from professional negligence claims, brokers are advised to provide written acknowledgement of advice, formalise recommendations, keep file notes and a checklist, obtain policy documents and not just invoices to display the cover that the insured has and does not have, and have in place standard practices and procedures that are documented and followed.

Any indication that a person or entity does not want certain cover or would not have taken it out if so advised, such as details of the client's insurance budget, should also be recorded on a file.

## KATHERINE FLOODS DECISION

An example of a professional indemnity claim against an insurance broker gave rise to the decision of the Federal Court of Australia in *Elilade Pty Ltd v Nonpareil Pty Ltd*.[8]

Elilade Pty Ltd bought a going concern called Terrace Tapes Music & Video World, which it operated at premises at Katherine Terrace from 1 July 1996.

Rain water entered the premises of the shop to some depth during 26 January 1998, causing damage to stock and plant in the premises. At about 6.00am on 27 January 1998, the Katherine River broke its banks and directly flowed into the premises. The second inundation rose to a depth of some 1.8 metres and the waters did not abate fully for some days.

The previous owners of the business had arranged their insurance through a broker, Nonpareil Pty Ltd, the first respondent to the proceedings. Elilade used the same broker to effect 'business pack' insurance from 1 July 1996, with the insurance issued by the second respondent, CIC Insurance Ltd.

Elilade attempted to claim $338,278.50 under the CIC policy for loss of plant and equipment, stock and the cost of removing debris. It also claimed interest under s57 of the *Insurance Contracts Act*.

CIC contended that it was not liable to indemnify. It accepted that the initial inundation was a defined event under the policy. However, its contention was that any damage to the stock or plant of the business was also caused by the second inundation. The second inundation was a '*flood*' as defined in the policy, so fell within an exclusion to the cover granted. It was argued in the alternative that the loss suffered from the initial inundation was not satisfactorily proved. Finally, it was argued that the inability of Elilade to remove and dry the stock after the first inundation was caused by the second inundation, so that the damage was >>

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effectively caused by the flood and indemnity did not extend.

Elilade also pursued Nonpareil on the basis that it failed to procure flood insurance, or advise that flood insurance should be taken out. The claim was framed against the broker in contract and in tort. It was alleged that it was a term of the contract between Elilade and Nonpareil that Nonpareil would procure the best policy to suit the needs of Elilade, and by procuring a policy with a flood exclusion, Nonpareil was in breach of that term of its contract. Elilade asserted that it was not informed of the flood exclusion and believed that it had flood cover.

Elilade also framed a statutory claim with reference to s44(e) of the *Consumer Affairs & Fair Trading Act* (NT). That section provided that:

> 'A person shall not, in trade or commerce, in connection with the supply or possible supply of goods or services or the promotion by any means of the supply of goods or services:
>
> (e) represent that the goods or services have sponsorship, approval, performance characteristics, accessories, uses or benefits that they do not have.'

Claims were also made for contraventions of s52(1) of the *Trade Practices Act* 1974 (Cth) and s42 of the equivalent Northern Territory legislation, and s13(1)(b) of the *Insurance (Agents & Brokers) Act* 1984 (Cth).

Nonpareil defended its claim on the basis that it did inform Elilade that the policy excluded cover for damage caused by flood. In the alternative, it was asserted that the duty of care owed to Elilade did not require Nonpareil to:

(a) procure insurance against damage by flood; or
(b) positively advise Elilade to procure flood cover; or
(c) inform Elilade that the insurance cover taken out excluded cover for damage caused by flood.

It was also submitted that Elilade had not proved that even if it had been so informed, additional insurance would have been taken out to provide flood cover.

Justice Mansfield of the Federal Court found that CIC was liable to indemnify Elilade for losses caused by the initial inundation, and quantified that loss in respect of stock contained on the bottom two shelves.

In relation to the balance of the claim, Justice Mansfield formed the view that Nonpareil was required to expressly raise the issue of flood insurance with Elilade, and to make it aware of the flood exclusion in the policy. Nonpareil was aware that the directors of Elilade were not well-experienced in addressing the insurance requirements of a business, and the broker was also aware of the significant risk of flood in Katherine.

Despite finding that Nonpareil failed to discharge the duty it owed to Elilade, Justice Mansfield concluded that this failure did not cause Elilade's loss. This was on the basis that Elilade would not have procured flood cover had Nonpareil raised the issue and expressly advised of the flood exemption in the policy. This conclusion was based upon the fact that Elilade's budgeted allowance for insurance was inadequate to cover the premiums had flood coverage been sought, and the inclination of Elilade's directors to proceed in a similar way to the previous owners of the business, who had not also procured flood insurance. As such, the claim against the broker failed.

## IF A CLAIM IS MADE

Any professional indemnity claim that is intimated or made should be reported to insurers immediately. Reporting a claim will not affect premiums if the claim is not pursued. However, not reporting a claim can preclude indemnity with respect to claims made and notified policies.

It is important that all relevant documents are preserved and provided to the insurer or its investigator or representative, including email correspondence and other computer files.

Apologies can be conveyed; however, admissions should not, as they may compromise the insurer's ability to defend a claim, and give rise to an argument against indemnity.

Practices and procedures that might assist in the defence of a professional indemnity claim should be documented and followed.

The Katherine floods decision referred to above is not the only decision to arise out of that flood in 1998, and the extent of litigation that will follow from recent events in Australia remains to be seen. ■

**Notes:** **1** *Elilade Pty Ltd v Nonpareil Pty Ltd* [2002] FCA 909. **2** *Newcastle City Council v GIO General Ltd* [1997] HCA 53. **3** *FAI General Insurance Co Ltd v Australian Hospital Care Pty Ltd* [2001] HCA 38; *Gosford City Council v GIO General Ltd* [2003] NSWCA 34. **4** [2008] HCA 30. **5** (1996) 38 NSWLR 556 at 568-9. **6** Other relevant decisions include: *Fitzpatrick v Jobs Engineering & Ors* [2007] WASCA 63; *Vero Insurance Ltd v Power Technologies Pty Ltd* [2007] NSWCA 226; and *Transfield Services (Australia) v Hall; Hall v QBE Insurance (Australia) Ltd* [2008] NSWCA 294. **7** [2006] 1 All ER (Comm) 789. **8** [2002] FCA 909.

**Emma Reilly** *is a partner at Moray & Agnew Lawyers in Canberra.* **PHONE** *(02) 6262 6922* **EMAIL** *ereilly@moray.com.au.*