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SUING THE INSURER DIRECT – LYTTTELTON MARINA AND SECTION 9 OF THE LAW REFORM ACT 1936

Introduction

1. Most, if not all, insurance lawyers in New Zealand will have some familiarity with the Christchurch High Court's decision in the Lyttelton Marina case - *Jaggar v Lyttelton Marina Holdings & Ors* [2006] 2 NZLR 87. The High Court decision has been appealed by QBE with the hearing taking place in the Court of Appeal on 9 August 2006.
2. At the time of writing, the Court of Appeal's decision had not been released. However the small part of the High Court decision that I am to talk about today was not part of the appeal. So the comments made in this paper are unaffected by the outcome of the appeal.

Section 9 of the Law Reform Act 1936

3. Most people involved in the insurance industry, on the claims side at least, will have some idea that section 9 of the Law Reform Act 1936 exists. Section 9 enables a plaintiff, in certain circumstances (most often a defendant's insolvency), to bring proceedings directly against the defendant's liability insurer. Overseas jurisdictions including England, Australia, Canada and even the United States, have similar legislative provisions. Section 9 (1) of the New Zealand Act provides that *where an insured has claimed under a contract of insurance by which he is indemnified against liability to pay any damages ... the amount of his liability shall, on the happening of the event giving rise to the claim for damages ... be a charge on all insurance money that is or may become payable in the respect of that liability.*



4. So section 9 operates by creating a statutory charge, enforceable by the plaintiff, over any insurance moneys payable to the insured. Put very simply, a plaintiff may sue an insurer direct when the insurer's client (i.e. the insured) has become insolvent, if the insurer otherwise would have provided a subrogated defence to the claim.
5. Over the years, there have been many decisions in New Zealand dealing with section 9. There was a flurry of activity in New Zealand following the Stockmarket crash of 1987 and the cases have continued since then. But our *Lyttelton Marina* research failed to find a single case where a Court had made a determination at trial on section 9. So "the right" to pursue an insurer under section 9 has been dealt with in an interlocutory context historically. As far as I am aware, the *Lyttelton Marina* decision is the only decision on section 9 (or its equivalent) at the end of a trial in New Zealand, Australia, England or Canada.
6. This is part of the reason why this aspect of the *Lyttelton Marina* decision is of interest. The other is that *Lyttelton Marina* seems to be the only case that considers what rights an insurer has to run defences available to an insolvent insured, where the insurer has elected to avoid the policy. Hence the reason for this paper.
7. When one looks through the section 9 cases (and cases on the equivalent sections overseas) most of the cases fall into one of two distinct categories. The first is the "hopeless" category. An example of this is *Independent Wool Dumpers Pty Limited v American International Underwriters (NZ) Ltd & Ors* (1993) 7 ANZ Insurance Cases 61-152. The plaintiff claimed for damage to the product itself, said to have arisen from the faulty design and manufacture of the product. American International's umbrella policy contained an exclusion for property damage to the insured's products arising out of the insured's products. As the exclusion clearly operated, leave to sue the insurer was refused.
8. The second category of cases is where there is in fact some real argument about the insurer's right to decline. A good example is a case where the insurer pleads, for example, a defective workmanship exclusion but the doubt about the facts mean that at an interlocutory stage a Court is unable to decide whether the exclusion will operate or not. An example of this sort of case is *David J Reid (NZ)*



Limited v C.E. Heath Casualty & General Insurance (NZ) Limited (1992) 7 ANZ Insurance Cases 61-137.

Avoiding the Policy – Of What Effect?

9. But none of the cases seem to have considered what rights the claimant and the insurer have where the insurer elects to avoid the policy *ab initio*. In *Lyttelton Marina* the insurer did just this, on the grounds of material non-disclosure.
10. But the insurer subsequently raised two new defences in its third amended statement of defence (contributory negligence and voluntary assumption of risk). The plaintiff applied to strike out these two defences on two grounds. First, the insurer was not entitled to advance defences available to the insureds because it had avoided the policy. Second, the insureds themselves had not raised those two defences and so QBE should not be permitted to do so.
11. As a matter of law, the effect of an avoidance *ab initio* is that the insurer asserts that it was never on risk – i.e. it is though the policy had never existed. As a consequence, the insurance premium must be returned on the basis of total failure of consideration (as it was in the *Lyttelton Marina* case). So the insurer in *Lyttelton Marina* was not saying that it was a case where either the insureds were not liable to the claimant, or that for some reason the claim did not fall within the policy coverage. The core of the defence was that *there was no policy*.
12. In such circumstances the insurer cannot plead its case on alternative bases. Either it was entitled to elect to avoid, or it was not. Whether or not it was so entitled the effect is the same, which is that the policy no longer exists. Where a policy has been avoided wrongfully, the remedy is damages (such damages in *Lyttelton Marina* being assessed at the level of the insureds' liability to the third parties). No claim can be paid under the policy. The policy is gone forever.
13. The election to avoid constitutes, as a matter of law, an unequivocal election to pursue one of two (or more) mutually inconsistent approaches to the insured's claim. In other words, the insurer decides to claim that the policy was never in place; rather than rely upon the policy terms to decline the insured's claim.



Obviously an insurer cannot rely on a policy's terms if it claims the policy never existed.

14. This is entirely different to where the insurer pleads a breach of policy condition or that a policy exclusion applies. In that circumstance the policy still stands, and the insurer is able to plead its defences relying on the policy itself.
15. So in *Lyttelton Marina*, the plaintiff's argument was that if the insurer's right to avoid the policy was found not to exist, the insurer could not raise defences available to the insureds. That was because the insurer was claiming that there never had been a policy in place. In other words, the insurer could not have it's cake and eat it too.
16. Put more formally, the insurer had resiled from the policy as a whole. It was inconsistent with the election made, to allow the insurer to then advance the insureds' defences, if the avoidance of the policy was found to have been invalid.

Section 9

17. The only problem with that argument, which at least on its face seems to make sense, is the actual wording of section 9. To aid the reader's understanding, the relevant parts of section 9 are set out in full below:

9. Amount of liability to be charge on insurance money payable against that liability -

- (1) *If any person (hereinafter in this Part of this Act referred to as the insured) has, whether before or after the passing of this Act, entered into a contract of insurance by which he is indemnified against liability to pay any damages or compensation, the amount of his liability shall, on the happening of the event giving rise to the claim for damages or compensation, and notwithstanding that the amount of such liability may not then have been determined, be a charge on all insurance money that is or may become payable in respect of that liability.*



- (2) *If, on the happening of the event giving rise to any claim for damages or compensation as aforesaid, the insured has died insolvent or is bankrupt or, in the case of a corporation, is being wound up, or if any subsequent bankruptcy or winding up of the insured is deemed to have commenced not later than the happening of that event, the provisions of the last preceding subsection shall apply notwithstanding the insolvency, bankruptcy, or winding up of the insured...*
- (4) *Every such charge as aforesaid shall be enforceable by way of an action against the insurer in the same way and in the same Court as if the action were an action to recover damages or compensation from the insured; and in respect of any such action and of the judgment given therein the parties 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...*
- (7) *No insurer shall be liable under this Part of this Act for any sum beyond the limits fixed by the contract of insurance between himself and the insured.*

18. Because the action to enforce the charge is one that asserts that money is payable under a policy, there are two different sets of rights and obligations operating in tandem. Firstly, the claimant's obligation to establish a liability on the part of the insured, and secondly, the claimant's statutory right to enforce the resulting charge against the insurer. But, section 9(4) expressly states that the action against the insurer to enforce the charge shall proceed "as if" the action were one to recover damages from the insured. But it is not an action against the insured. It does not become an action against the insured.
19. Section 9(4) then provides that in respect of any such action "*the parties shall to the extent of the charge, have the same rights and liabilities... as if the action were against the insured*". Presumably the reference in section 9(4) to "the parties" can only mean the "claimant" and "the insurer". The "insured" is plainly outside the scope of the words in the section for these purposes. Nonetheless one has to consider what those rights and liabilities might be.



20. The *UEB Packaging* decision (*UEB Packaging Limited v QBE Insurance (International) Limited* [1998] 2 NZLR 64 (CA)) interpreted section 9 as meaning the claimant can be in no better position against the insurer than was the insured. But surely the logical corollary of this is that the insurer should be in no better position against the claimant, than it would be against the insured. In other words, the insurer can run only the arguments that would have been available to it, had a claim been brought against it by its own insured. Mr Jaggar in the *Lyttelton Marina* case argued that the insurer was trying to do more than this by mounting defences (in particular, a contributory negligence defence) that would in the normal course of events only be available to the insured, and so was effectively seeking to *improve* its position.
21. To allow the insurer to allege both an entitlement to avoid, as well as to advance the insureds' defences, is to allow the insurer to have it both ways. This is inconsistent with the election it has made and with the effect of section 9(7). The insurer should not be in a better position against the third party claimant, than it would have been against the insured, said Mr Jaggar.
22. The improvement of the position of the insurer was clearly not the intention of section 9. That section does nothing more than create a means by which a third party can enforce against the insurer; rights that otherwise would be pursued against the insured and where the insured would then claim against the insurer.

*I view s 9 as creating a statutory mechanism for permitting the enforcement of an **otherwise established right** where there is an applicable insurance fund potentially available. The respondent is not given new, different or greater entitlements under the Act. It was necessary for *Blundell and Brown Ltd* to establish that it had rights against Mr Leishman. Because Mr Leishman might have relevant insurance cover, *Blundell and Brown Ltd* is seeking...to enforce the satisfaction of that established right against an indemnifier of Mr Leishman. The respondent cannot claim any more than it could otherwise have done. The charge from which it seeks recovery is limited to the terms of the contractual arrangement between the appellant and Mr Leishman.*



FAI (NZ) General Insurance Co Ltd v Blundell and Brown Ltd [1994] 1 NZLR 11 (CA)

23. It is relevant that section 9(5) expressly contemplates that an action against an insurer may be preceded by an action against the insured in which judgment is obtained. It surely would not be open to the insurer to contest a judgment against its insured, or to assert that judgment would not have been entered had the insured conducted the case differently. Issues of res judicata and issue estoppel would arise. The sole matter for determination in a subsequent proceeding against the insurer would be whether or not the policy should respond. So logically, how can an insurer that has elected to avoid a policy run arguments that the insured itself was not running?
24. There is no reason in principle why the position should be different in the present circumstances, and there are good reasons why it should not be different. It makes no practical sense for the insurer to be able to assert the insured's defences in a section 9 argument, when it would not be able to do so in a case where the third party claimant has turned to the insurer after having first obtained, say, a formal proof or default judgment against the insured. The sole issue (as between the claimant and the insurer) should be whether the terms of the contractual arrangement between the insured and the insurer give rise to a charge which is enforceable by the claimant.
25. In this respect, the position in New Zealand is the same as in England. The English equivalent to section 9 is section 1 of the Third Parties (Rights Against Insurers) Act 1930. Although the section is worded differently, the same public policy intention of giving protection to claimants in respect of liabilities incurred by those who are insolvent but insured, is evident:

The effect of section 1 has been described as a statutory assignment, which implies, say the courts, that the third party steps into the shoes of the insured. From this certain things follow...It follows also that [the third party's] rights are limited by defences that the insurer would have had in an action by the insured...Rights transferred to the third party are subject to all defences available to the insurer, whether they concern the avoidance of



cover such as non-disclosure, the extent of cover such as exceptions, or procedural conditions such as notice. The third party takes the wrongdoer and the wrongdoer's insurance as he finds them. One judge made the somewhat dated observation that the third party cannot "have the plums without the duff".

The Law of Insurance Contracts, Clarke, tenth Service Issue, paras. 5-8D and 5-8E

26. The importance of the public policy foundation for the legislation was virtually taken for granted in *Total Graphics Ltd v AGF Insurance Ltd* [1977] 1 Lloyd's Rep 599 at 606 where Mance J. held:

Mr Falconer submitted that, even if the liability incurred by [the insured] fell within the scope of the policy properly construed and applied, still it would be contrary to public policy to allow a recovery that would have the effect of indemnifying [the insured] against the fraud of its alter ego, Mr Groom. I see no merit in this submission. The effect of the 1930 Act is to entitle an innocent third party, TGL, to indemnity in respect of [the insured's] liability to it so far as such liability falls within the scope of [the insured's] professional indemnity insurance. Public policy creates a personal disability to recover. There is no reason why TGL should be affected by any defence of public policy, if any, that would have affected [the insured].

27. The same public policy intention is given effect in the United States, where a third party is even entitled to plead against an insurer, an estoppel arising out of the insurer's dealings with the insured.

The Law of Insurance Contracts, supra at para.5-8F1

The Court's Decision

28. So at the end of the day, there were 2 competing arguments with little, if any, legal authority either way. Mr Jaggar's argument was that as the insurer had elected to avoid the policy, it could not run defences available to the insured (in particular, a



defence of contributory negligence). Particularly when the insureds in fact had not run those defences. The contrary argument was that the specific words of section 9 meant that the insurer had the “same rights and liabilities, as if the action were against the insured”. So notwithstanding the avoidance of the policy, the insurer could argue everything that the insureds themselves could have argued in their defence.

29. For those of you who do not know the outcome, the insurer prevailed. Justice Pankhurst said this at paragraphs 37 & 38:

To my mind the result contended for the [the insurer] follows naturally from the words used in s9(4). Assuming that there is cover under the policy, QBE is entitled to raise any defence which the third and fourth defendants could have raised (not did in fact raise). In addition, QBE may also defend on the basis that it validly avoided the policy for misrepresentation or non-disclosure. Its stance in that regard does not prevent QBE from asserting affirmative defences which would ordinarily lie in the mouth of the insured.

[38] Thereby, QBE does not have the best of both worlds, as Mrs Barratt put it. Rather, the circumstances that QBE raised both defences ordinarily available to the insured, and defences pertaining to the insurance contract, reflects the circumstance that a claim such as this involves in effect two claims running in tandem.

30. But despite the fairly short shrift that Mr Jaggar’s argument receives at paragraphs 31 to 40 inclusive of the judgment, my own view is that there is more of a valid argument than the judgment would have you believe. One of the principal reasons I think this is because otherwise there would be no dis-incentive for an insurer to try to avoid a policy of an insolvent insured. The insurer could avoid, and hope that the avoidance was upheld in due course, without suffering any detriment whatsoever should a Court ultimately hold the policy could not be avoided.
31. Not only that, but reliance on the strict wording of section 9(4) rather skips around the well established principle of insurance law that says that where an insurer elects to avoid a policy, the law presumes that no policy has ever been in force. No mention of this point is made in the Judge’s decision in the *Lyttelton Marina*



decision. Rather, Justice Pankhurst says “assuming that there is cover under the policy”. But this, with respect, misses the point that there is no policy where an insurer avoids a policy ab initio.

The Result for New Zealand Insurers

32. From an insurer’s perspective, the result is a welcome one. There is now High Court precedent expressly allowing an insurer to avoid a policy in a section 9 case and as well, to run any defences available to the insured should the avoidance of the policy fail. This is as good as it can ever get for an insurer, so long live *Lyttelton Marina!*

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