

“GETTING THE MEANING RIGHT: THE CORRECT APPROACH TO INTERPRETING INSURANCE CONTRACTS”

The Hon Justice A J Meagher, Judge of Appeal, Supreme Court of New South Wales

(Australian Insurance Law Association, 4 December 2019)

General observations

- 1 Statements as to the “correct approach” to the construction of commercial contracts are familiar. An often repeated one is that of Gleeson CJ in *McCann v Switzerland Insurance Australia Ltd* (2000) 203 CLR 579; [2000] HCA 65 at [22]:

A policy of insurance, even one required by statute, is a commercial contract and should be given a businesslike interpretation. Interpreting a commercial document requires attention to the language used by the parties, the commercial circumstances which the document addresses, and the objects which it is intended to secure.

- 2 Two significant doctrines or rules underlie and inform this statement.
- 3 The first is the objective theory of contract which dictates that the rights and liabilities of the parties under a contract are to be determined objectively. Accordingly “it is necessary to ask what a reasonable businessperson [in the position of the parties] would have understood [the terms of the commercial contract] to mean”: *Electricity Generation Corporation t/as Verve Energy v Woodside Energy Ltd* (2014) 251 CLR 640; [2014] HCA 7 at [35]; *Mount Bruce Mining Pty Ltd v Wright Prospecting Pty Ltd* (2015) 256 CLR 104; [2015] HCA 37 at [46]-[47].
- 4 As the learned author of *Heydon on Contract* (2019, Law Book Co at [8.130]) emphasises:

It does not matter what the parties believe the words of the contract to mean. Nor does it matter what subjective intentions of the parties may have underlined their negotiating stances and tactics. All that matters is what is expressed by the language they chose. The concern is not with the “real intentions of the parties, but with the outward manifestations of those intentions”.

- 5 The second is the “parol evidence rule”, the broad purpose of which, in relation to a contract which has been reduced to writing, is “to exclude extrinsic evidence (except as to surrounding circumstances), including direct statements of intention (except in cases of latent ambiguity) and antecedent negotiations, to *subtract from, add to, vary or contradict the language*” of the written instrument: *Codelfa Construction Pty Ltd v State Rail Authority of NSW* (1982) 149 CLR 337 at 347 (Mason J) (emphasis added); [1982] HCA 24.
- 6 There remains controversy as to whether ambiguity is necessary before recourse may be had to evidence of surrounding circumstances. In *Codelfa Construction* at 352, Mason J described the “true rule” to be that “evidence of surrounding circumstances is admissible to assist in the interpretation of the contract if the language is ambiguous or susceptible of more than one meaning. But it is not admissible to contradict the language of the contract when it has a plain meaning”.
- 7 In *Mainteck Services Pty Ltd v Stein Heurtey SA* (2015) 89 NSWLR 633; [2014] NSWCA 184, the NSW Court of Appeal regarded this statement as applying at the outset of the construction process and irrespective of whether the contract is ambiguous or presents a constructional choice. That view has been criticised by the author of *Heydon on Contract* (at [9.990]); and while in *Mount Bruce v Wright Prospecting* at [49] the High Court said that evidence of surrounding circumstances was admissible “in determining the proper construction where there is a constructional choice”, it also emphasised that the question whether recourse may be had to that material in order to “identify the existence of a constructional choice” has not been determined by that Court. That still remains the position.
- 8 However this controversy rarely presents evidentiary difficulties in relation to the construction of insurance policies because if there is a contest about the construction of the policy, that would give rise to a constructional choice justifying the admission of evidence of surrounding circumstances.

- 9 Furthermore as one commentator has observed (Tom Prince, “Defending orthodoxy: *Codelfa* and ambiguity” [2015] 89 *ALJ* 491 at 498):

A contract can still be construed in a “businesslike” way, or in a “commercially sensible” manner, or by having regard to the “commercial circumstances which the document addresses”, without [extrinsic] evidence of surrounding circumstances. Often, what is businesslike or commercially sensible is a matter of submission not evidence, and the commercial circumstances which the document addresses will be obvious from the document itself.

- 10 When I am faced with a question of construction involving a policy of insurance, I start with the nature of the insurance – is it primary or excess and direct insurance or reinsurance? Assuming the insurance to be primary and direct, I then consider the wording and schedule. The latter will identify the insured, whether as contracting parties or otherwise, the sums insured and deductibles.
- 11 The way in which the provisions of the policy describe and define that event or risk obviously will vary between different policies. There are many so-called rules of construction. The words are to be given a businesslike construction. This of course ultimately requires that the court assess what business common sense involves or requires in a particular case, usually in circumstances where each party contends that the “businesslike” interpretation coincides with its own interest. Words with a technical meaning are to be given that meaning and evidence is admissible to explain a trade usage or technical meaning of a word. The document should be construed so that looking at its various components it makes sense as a whole. If possible, meaning should be given to all of the words used unless doing so produces irrational consequences or is inconsistent with the purpose of the cover. Ultimately the task of interpretation involves identifying and then testing the competing constructions against the other provisions of the policy and the commercial consequences of those rival meanings.

***XL Insurance Co SE v BNY Trust Company of Australia Limited* [2019] NSWCA 215**

12 The policy in *XL Insurance Co SE v BNY Trust Company of Australia Limited* was a professional indemnity insurance issued to a property valuer. The insuring clause indemnified against “Loss” (defined to include compensatory damages) incurred by the insured in respect of any claim first made and notified during the policy period arising from the performance of Professional Services.

13 The policy schedule included an Endorsement for valuers which contained specific exclusions, the subject matter of which included valuations undertaken by or on behalf of the insured.

14 The relevant exclusion provided:

The Insurer will not be liable to indemnify the Insured for any Loss... directly or indirectly arising out of, based upon, attributable to or in consequence of:

...

(ix) any valuation undertaken by, or on behalf of, the Insured for any lender ... that is not an Authorised Deposit-Taking Institution supervised by the Australian Prudential Regulatory Authority (APRA) unless the following "Prudent Lender Clause" (or a clause with materially the same effect) is included in any such valuation report:

[valuation assumes that the lender may rely on the valuation for mortgage finance purposes, that the lender has complied with its own lending guidelines as well as prudent finance industry lending practices, and has considered all prudent aspects of credit risk for any potential borrower, including the borrower's ability to service and repay the loan. It is also prepared on the assumption that the lender is providing mortgage financing at a conservative and prudent loan to value ratio]

15 The primary judge held that the exclusion operated *only* where there was a causal connection established between the “Loss” and the *absence* of a Prudent Lender Clause; concluding that “the introductory words [to the exclusions] are concerned with losses *caused* by the matters dealt with in the clauses which follow, in the case of clause (ix), by the failure to include a prudent lender clause in a valuation”: *BNY Trust Company of Australia*

Limited v MMJ Real Estate (WA) Pty Ltd (No 2) [2018] NSWSC 1938 at [32]. As one of the appeal judges observed, the real difficulty for the insured in formulating the construction for which it contended was doing so “without including words that do not appear or by excluding words that appear in the endorsement” (at [132]).

- 16 The leading judgment in the Court of Appeal was delivered by Justice Fabian Gleeson. Having considered the literal meaning of the exclusion, he concluded that it was difficult to detect any ambiguity in the exclusion arising from the introductory words. He noted (at [71]) that the insured’s construction would render much of the first three lines of the provision “superfluous”. He also observed that this was not a case where it was appropriate to construe the language in a way which made particular words redundant. “That may be appropriate where the alternative construction of the words is inconsistent with other provisions of the contract or where the alternative construction is inconsistent with the commercial purpose of the contract or where it appears that the words have been included out of abundant caution” (at [72]).

***Malamit Pty Ltd v WFI Insurance Ltd* [2017] NSWCA 162**

- 17 Malamit, which provided project and development management services, was insured by WFI Insurance under a policy of professional indemnity insurance. The insuring clause indemnified the insured “for any CLAIM for compensation first made against the INSURED” and reported during the policy period. “Claim” was defined to mean “any civil proceeding brought by a third party against the INSURED”.
- 18 The claim was brought by Treetops, a company associated with the sole shareholder of Malamit, and an insured under the policy, although not a contracting party. The insurer denied liability, including, on the basis that Treetops was not a “third party” within the definition of “claim”.
- 19 Addressing the language of the definition of “claim”, the reference to a “third party” could be to someone who was not a party to the contract of insurance,

to someone who was not an insured under that contract or to anyone other than the particular insured against whom the claim was made.

- 20 The policy was a “composite” contract in the sense that the insurer promised to indemnify a number of insureds with respect to their several interests. Ordinarily such an insuring clause is to be read as indemnifying each insured in respect of its interests and that indemnity will not necessarily be affected by circumstances specifically pertaining to another insured: *Federation Insurance Ltd v Wasson* (1987) 163 CLR 303 at 310-311, 314, 318-319; [1987] HCA 34. Accordingly the policy was to be construed “distributively” and as applying separately to each insured.
- 21 The insured was indemnified against “claims made and notified”. Various types of claims were then excluded. The purpose of the exclusions was to narrow the scope of the cover. It followed, as Viscount Sumner observed in *Lake v Simmons* [1927] AC 487 at 507, that the exclusions were to be read and understood on the basis that they were presumed to “cut out something already included by the general recitals and provisions”.
- 22 The relevant exclusion (cl 7.15(a)) excluded from the subject matter of cover “a CLAIM by, on behalf of or for the benefit of *any* INSURED” (emphasis added). Its premise was that a proceeding brought by one insured against another was a claim that would otherwise be within cover. The expression “third party” within the definition of “claim” should be construed in accordance with that premise. That was only achieved if it described any person other than the insured against whom the proceeding had been brought.
- 23 This case is an illustration of the rule that “in construing the policy, as with other instruments, preference is given to a construction supplying a congruent operation to the various components of the whole” (see *Wilkie v Gordian Runoff Ltd* (2005) 221 CLR 522; [2005] HCA 17 at [16]).

Lilly v Ewer (1779) 1 Dougl KB 72; 99 ER 50

- 24 When Lord Mansfield was Chief Justice of the Court of King's Bench, insurance cases were usually heard by a judge and jury. In cases involving questions of commercial usage or practice, Lord Mansfield often assembled a "special jury", its members including "many knowing and considerable merchants".
- 25 The brief note to this report dated 6 February 1779 reads "In a policy of insurance, "sailing with convoy" means "sailing with convoy for the voyage"". The question was whether the insured was entitled to a return of part of the premium. That depended on whether a condition requiring that "the ship sailed with convoy from Gibraltar" was satisfied if the ship departed from Gibraltar in a convoy until the port of Lisbon after which it sailed the balance of the voyage to London alone. The trial was heard by Lord Mansfield with a common jury (one not specifically qualified) which entered a verdict for the plaintiff insured.
- 26 The insurer applied to have that verdict set aside by the Full Court. Lord Mansfield presided. There is reference in the report to the evidence called at the trial which supported the respective constructions argued for by the parties, as one might expect. The report records Lord Mansfield saying during argument that the evidence was not led "to ask the opinion of the witnesses on the construction, but to learn whether there was any usage in this case which would give a fixed technical sense to the words"; and that the question of usage was "a question of fact to be ascertained by evidence, and proper for the consideration of a jury".
- 27 At the conclusion of argument on the question of construction, the judgment delivered by Lord Mansfield includes:

On the words, I was strongly of opinion, that the policy meant a departure with convoy intended for the voyage. The parties could not mean a departure with convoy which might be designed to separate from the ship in a minute or two; though, when convoy for the whole of a voyage is clearly intended, an unforeseen separation is an accident to which the underwriter is liable...

Certainly critical niceties ought not to be encouraged in commercial concerns; and wherever you render additional words necessary, and multiply them, you also multiply doubts and criticisms.

***Globe Church Incorporated v Allianz Australia Insurance Ltd* [2019] NSWCA 27**

- 28 The issue in this case was whether the insured's claim to an indemnity for property damage under an Industrial Special Risks Policy was statute-barred, the insurer arguing that the insured's cause of action for breach of that contract arose at the instant any property damage occurred. Allianz insured Globe Church under the policy for damage occurring during the period 31 March 2007 to 31 March 2008. In September 2009 it made a claim for damage to the footings of its church building which had occurred during the period of that insurance. Proceedings for an indemnity were commenced in November 2016, more than six years after March 2008 (at [216]-[218]).
- 29 A promise to indemnify, depending on its terms and context, may require the indemnifier to compensate the indemnified party for a loss which it has suffered, or it may go further and require the indemnifier to prevent the indemnified party from suffering that loss at all. In *Collinge v Heywood* (1839) 9 Ad & E 633 at 639-641; 112 ER 1352 at 1354 the indemnity which was "to save, defend, and keep harmless and indemnified" Collinge against the costs and expenses incurred in commencing and prosecuting proceedings for the wrongful distraint of goods was held to be breached upon Collinge suffering loss by being called upon to pay.
- 30 The majority of the Court of Appeal in *Globe Church* upheld the insurer's argument that the obligation to "indemnify" required that it hold the insured "harmless" against physical loss, damage or destruction, with the necessary consequence that the insurer was in breach of that obligation immediately upon the happening of any property damage, thereby giving rise to an immediate action for unliquidated damages against the insurer. In doing so, the Court applied the position under English law which is that promises to indemnify in contracts of insurance are to be understood as undertakings to prevent the insured from suffering loss or damage. That being the position is supported by the obiter statement of Lord Goff in *Firma C-Trade SA v*

Newcastle Protection and Indemnity Association (The Fanti) [1991] 2 AC 1 at 35-36, that “once the loss is suffered or the expense incurred, the indemnifier is in breach of contract for having failed to hold the indemnified person harmless against the relevant loss or expense”.

31 Unsurprisingly there has been much criticism of that being the position under English law by various academics and commentators. Furthermore it is not the position under the law of Scotland which is that “the insurer’s obligation is characterised as a contractual duty to pay a sum of money equivalent to the insured’s loss. An insurance payment is not therefore characterised as damages, but as a debt due under the contract”: Law Commission and Scottish Law Commission, *Insurance Contract Law: Business Disclosure; Warranties; Insurers’ Remedies for Fraudulent Claims; and Late Payment* (Law Com No 353/Scot Law Com No 238, July 2014) at [25.25].

32 The current edition of *MacGillivray on Insurance Law* (14th ed, 2018, Sweet & Maxwell at 667) refers to “the illogicality of the present law of deeming the insurer to be in breach of an obligation to indemnify before he had an opportunity to perform it”. More colourfully, Professor Malcolm Clarke (“Nature of Insurer’s Liability” [1992] *LMCLQ* 287 at 288) observed in criticising the reasoning in *Apostolos Konstantine Ventouris v Trevor Rex Mountain (The Italia Express) (No 2)* [1992] 2 Lloyd’s Rep 281 which applied that construction:

The role of the insurance industry in preventing loss by advice is of undoubted value, but the picture of P & I Club managers patrolling Piraeus or Lloyd’s names snooping around Surbiton [a suburb of southwest London] as some kind of neighbourhood watch bears thinking about, though only just. The construction of a contract which finds a promise which both parties know the promisor cannot possibly keep, was described by counsel for the plaintiff [in *The Italia Express*] as ‘absurd’ and, certainly, should give some pause for thought.

33 The interpretation of a policy of fire insurance as indemnifying by compensating is not novel. In *Castellain v Preston* (1883) 11 QBD 380, Cotton LJ (at 393) described a policy of fire insurance as being:

The policy is really a contract to indemnify the person insured for the loss which he has sustained in consequence of the peril insured against which has happened, and from that it follows, of course, that as it is only a contract of indemnity, it is only to pay that loss which the assured may have sustained by reason of the fire which has occurred. In order to ascertain what that loss is, everything must be taken into account which is received by and comes to the hand of the assured, and which diminishes that loss. It is only the amount of the loss, when it is considered as a contract of indemnity, which is to be paid after taking into account and estimating those benefits or sums of money which the assured may have received in diminution of the loss.

34 In 1932, Welford and Otter-Barry wrote in *The Law Relating to Fire Insurance* (3rd ed, 1932, Butterworths & Co at 301):

The insurers do not, immediately upon receipt of the assured's claim, pay (a) the sum demanded by him, since they are entitled to be satisfied as to the fact of the loss alleged to have been sustained and its extent (b).

Two questions have, therefore, to be determined in the first instance, namely:

- (1) Whether the insurers are liable for the loss; and
- (2) What is the amount which the insurers have to pay upon the assumption that they are liable for the loss.

35 In *CIC Insurance v Bankstown Football Club* (1997) 187 CLR 384; [1997] HCA 2 the High Court considered the meaning of an insuring clause and basis of settlement clause in a policy of industrial special risks insurance which was not materially different from that considered in *Globe Church*. Referring to contracts of fire and other insurance of property, the plurality observed (at 396) "although other modes of discharge of the liability [to indemnify] may be stipulated by the particular contract or substituted with the consent of the insured, the liability of the insurer to make good the loss under the policy is one discharged by payment in money to the insured". Turning specifically to the reinstatement and replacement provisions, the plurality considered (at 401-402) that the effect of these provisions was that the undertaking of the insurer "was to indemnify the [the insured] against physical loss, destruction or damage occurring during the period of insurance. The fundamental obligations of [the insurer] under the Policy after the occurrence of the first fire were, within a reasonable time of the receipt of the claim (which was made promptly), to acknowledge liability and then to pay the liquidated sum, for the computation of which the Policy provided".

***Allianz Australia Insurance Ltd v Certain Underwriters at Lloyd's of London
Subscribing to Policy Number B105809GCOM0430 [2019] NSWCA 271***

- 36 The relevant insured, Baulderstone, was covered under two policies, but in neither case as a contracting party. The Allianz policy was issued to the Roads and Traffic Authority (RTA) and Baulderstone was insured under that policy as a contractor of the RTA. The Lloyd's policy was issued to Baulderstone's holding company and Baulderstone had the benefit of that insurance as a subsidiary. The relevant liability of Baulderstone was to a subcontractor injured in a work accident.
- 37 The question was whether there was double insurance in circumstances where each policy contained a provision which addressed the existence of "other" insurance. If the result of construing the policies independently was that each would respond to the liability but for the existence of the other, the relevant "exclusion" was to be treated as cancelling the other out with the result that both insurers would remain liable. That outcome is achieved as a matter of construction by excluding "from the category of co-existing cover any cover which is expressed to be itself cancelled by such co-existence": *Weddell v Road Transport and General Insurance Co Ltd* [1932] 2 KB 563 at 567-8 (Rowlatt J).
- 38 The Lloyd's policy contained a general exclusion providing that it did not cover liability that was the subject of insurance by any other policy. The Allianz policy included an "other" insurance clause which in the event that there was other "valid and collectible insurance" converted the cover under that policy to insurance which was "excess" of the cover provided by the other "underlying insurance". The Allianz policy provided that if there was such underlying insurance, in addition to that excess cover, it provided "difference in conditions" cover at the primary insurance level.
- 39 The resolution of the issues of construction of the Allianz policy was assisted by an understanding of the nature of the "difference in conditions" cover and the commercial sense in an insured such as the RTA, whilst taking the benefit of insurances arranged by its contractors, also ensuring that the scope of the

primary cover available to them was uniform and the same as that provided under the RTA's policy with Allianz.