Section 46
Insurance Contracts Act

When can an insurer exclude cover for pre-existing defects?

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Introduction

Section 46 of the Insurance Contracts Act is an unexplored provision of the Act. While some sections, most notably section 54, have been tested in many cases and taken to the High Court for clarification, there are no cases which consider section 46.

And yet it is an important section for some types of risk.

Like most provisions in the Insurance Contracts Act, section 46 is designed to protect the insured. Under section 46, the insurer cannot refuse a claim on the basis of a pre-existing defect unless it can be shown that the insured either knew about the defect or reasonably ought to have known of the defect. The section is worded as follows:

46(1) This section applies where a claim under a contract of insurance (other than a contract of insurance that is included in a class of contracts declared by the regulations to be a class of contracts in relation to which this section does not apply) is made in respect of a loss that occurred as a result, in whole or in part, of the defect or imperfection in a thing.

46(2) Where, at the time when the contract was entered into, the insured was not aware of, and a reasonable person in the circumstances of the insured could not be expected to have been aware of, the defect or imperfection, the insurer may not rely on a provision included in the contract that has the effect of limiting or excluding the insurer’s liability under the contract by reference to the condition, at a time before the contract was entered into, of the thing.

Sutton states:

"Thus, the section seeks to curb the impact of an all-embracing exclusion clause by limiting the responsibility of the assured to defects or imperfections which he or she either was aware of or which a reasonable person in the circumstances could be expected to have known about at the time the contract was made."

Overview of Section 46

To summarise, section 46 applies where two conditions are satisfied. Firstly, the insured’s claim arises out of loss caused by a defect in a thing. Secondly, the insured did not know (and could not reasonably have known) about the defect at the time of taking out the
insurance. If both conditions are satisfied, any clause which attempts to exclude cover by reference to the defect is void. In other words, the insurer cannot exclude cover for pre-existing defects except where the insured knew, or should reasonably have known, about the defects.

But section 46 does not apply to every insurance contract. Under 46(1), the regulations may set out types of insurance to which s46 does not apply. These exempt classes are set out in Regulation 30 of the Insurance Contracts Act. The exempt classes include construction risks contracts, industrial special risks and commercial risks contracts, and some products liability and broadform accidental loss and damage contracts. In contracts which come under this exempt class, s46 does not apply at all, meaning that the insurer is at liberty to exclude cover for pre-existing defects, even those defects of which the insured could not reasonably have been aware. We will consider these defects later but first I want to look at the scope and operation of section 46.

### Comparing section 46 with duty of disclosure under section 21

But for the protection of section 46, the insurer would be able to impose an onerous burden on the insured. Without section 46, the insurer could exclude liability for all pre-existing defects, even those which the insured could not have known about. Kelly & Ball conclude that allowing an insurer to impose that sort of a restriction "would have the same effect as a rule requiring the insured to disclose material facts whether he knew them or not".² Or, as Professor Sutton puts it, "If full effect is given to the exclusion clause, the assured in effect warrants that the thing is in perfect condition".³

Clearly that is an unreasonable requirement on the insured. The drafters of s46 considered it unreasonable for the insured to bear the full risk of unknown and unforeseeable pre-existing

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² Kelly & Ball, Principles of Insurance Law in Australia and New Zealand (Butterworths, Sydney, 1991) at 242.
defects. Section 46 effectively shifts the risk for these defects back onto the insurer. In the light of section 46, the insured only bears the risk for defects of which it knew or reasonably ought to have known. The insurer bears the risk for any undetectable defects.

The insured’s general duty of disclosure is set out in section 21 of the *Insurance Contracts Act*. Under section 21, the insured is required to disclose matters which:

1. are known to the insured; and either
2. the insured knows are relevant to the insurer’s decision of whether to accept the risk; or
3. a reasonable person in the circumstances could be expected to know would be so relevant

The insured is only required to disclose defects which are known to the insured, or ought to be. If insurers could exclude cover for defects which could not be known to the insured, they would effectively be extending the insured’s section 21 duty of disclosure, requiring them to disclose matters outside their reasonable knowledge. Instead, section 46 ensures that the duty of disclosure with respect to defects is in line with the general duty of disclosure in section 21.

Section 46 thus prevents insurers from extending the insured’s duty under section 21 by effectively requiring the insured to disclose defects which they did not know about. Under section 46, the insurer may only exclude for defects which were known to the insured, or ought reasonably have been known to the insured, and this is exactly in keeping with the duty of disclosure created by section 21.

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Exploring the limits of s46

The Policy

Before the wording of Section 46 can be invoked by an insured, the claim must fall within the policy definition of the claim. That is to say, the policy of insurance taken out by the insured must respond to the claim.

For example, many property damage policies are limited by the actual events for which they will cover the insured. They may not cover flood but only damage caused by fire.

It is therefore imperative that an adjuster ensures the policy actually responds to the claim prior to examining whether Section 46 applies in the circumstances.

Renewals, extensions & variations

Under s11(9) of the Act, any reference to entering into a contract of insurance also includes renewing, extending, varying or reinstating the insurance. So the insurer is restricted from relying on pre-existing defects at the time of each renewal, extension or variation as well as at the original formation of the policy.

Pre-existing

It should be first noted that the section is in fact quite limited in that it clearly distinguishes between exclusions which go to exclude pre-existing defects from exclusions which may provide for refusal of a claim where, for instance, the subject matter of the insurance was not kept in good repair or the like.  

Objective and Subjective Tests

As with many other provisions of the Act (such as s21 on the insured’s duty of disclosure) there is both an objective test and a subjective test. Firstly, the insured must not as a matter of fact have known of the defect. This is a relatively simple test. Secondly, it must be shown that a reasonable person in the circumstances “could not be expected to have been aware of” the defect.

What does that test mean? Professor Sutton thinks it is a lower standard than in the case of negligence. He interprets the word “could” as importing a lower standard than mere negligence.\textsuperscript{5}

Thus, where a ceiling was in good condition prior to entering into the policy of insurance, and the ceiling was subsequently damaged, then section 46 would not apply to the claim. The evidence to establish when the defect arose may cause loss adjuster and solicitor and insurer a fear problem.

The test asks what a reasonable person “in the circumstances” could be expected to know. The use of the phrase “in the circumstances” suggests a degree of subjectivity, that is, factors such as the degree of expertise possessed by the insured should be considered. However, the test is not entirely subjective. The original draft of the section, which read “in the circumstances of the assured”,\textsuperscript{6} was rejected in favour of the current, more objective wording.

The relevant time to assess whether the insured knew or ought to have known of the defect is the time of entering into the contract. Under section 11(9), entering into a contract also includes extending, varying, renewing or reinstating, so the insured’s knowledge of a defect must be reassessed at each renewal or extension.

\textsuperscript{5} Sutton, \textit{Insurance Law in Australia}, (3\textsuperscript{rd} Edition, LBC).
Pre-Existing defect need not be the sole cause of the loss

Section 46(1) applies where loss results “in whole or in part” from a defect or imperfection in a thing. In some cases, loss will result from a number of causes, for example where there are several defects, but only some of them existed at the time of entering the contract. In this case, section 46 means that the insurer cannot exclude cover for any of the loss. As soon as it is established that the loss resulted partly from a pre-existing defect, section 46 begins to operate.7

Onus is on the Insured

Who bears the onus of proving whether the insured knew or should have known of a pre-existing defect? Professor Sutton argues that, for practical reasons, the onus will fall on the insured, because it would be difficult for the insurer to prove the insured’s state of knowledge.

In practice, the insured would give evidence that they did not, as a matter of fact, know of the defect. In many cases, the insured would then be required to call evidence from an expert in the product concerned to say whether the defect would have been detectable, and from someone with expertise in the insured’s business to say whether a reasonable person in that business ought to have had the knowledge to detect the defect.

What is a “thing”?

Section 46 applies where there is a defect or imperfection in a “thing”. But what is a thing? Clearly, a car would be a thing, or a mechanical tool, or a piece of building material. Could a person conceivably be a thing? Could a piece of defective legal advice be a thing? Or a document such as a contract?

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6 CCH, Australian and New Zealand Insurance Reporter, vol 1 20,552.
7 Sutton, Insurance Law in Australia, (3rd Edition, LBC) at 882-883
There are no cases on the meaning of a "thing" in the context of section 46. In *The Queen v Ditmar*\(^8\) the court had to consider a statute which made it illegal to have in your possession "any thing" which may reasonable be expected of being stolen. The accused was charged with possessing $220 in bank notes which were suspected of having been obtained by the sale of drugs. The court consulted the Oxford Dictionary and found that the word "thing" included an inanimate object, and therefore included money. The court found that money was a thing for the purposes of that section.

In *Minister for Community Services and Health v Carter*\(^8\) the court considered s130 of the *Health Insurance Act* (1973), which stated that the Department of Health did not have to divulge "*any matter or thing*" which had come to its notice in the performance of its duties. The Department had some documents which it did not wish to disclose, and it argued that a "matter or thing" which it did not have to disclose included a document. The court rejected previous cases saying that a document was a thing. The court did not adopt a general definition of a thing, but rather looked at the context of the Act and section in which the word was used. In this case, the drafters of the Act had used the word "document" in the previous section, but in the disputed section had obviously chosen to use "matter or thing" instead. Hence, a document was not a thing, and the Department was not protected by s130 from disclosing it.

So the meaning of a thing is not fixed, but depends on the context of the section in which it is found. On the one hand, it could be implied that a thing must be a physical object. Section 46 applies where there is a "defect or imperfection" in a thing. You could argue that a defect is usually understood to mean a physical fault, so in order to have a defect, a thing must be a physical object. However, the word "imperfection" is broader, and could apply to esoteric concepts, such as legal advice, or a medical opinion.

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\(^8\) [1973] 1NSWLR 722
It would be in the interests of the insured to expand the definition of a thing, since it expands the class of items for which an insurer cannot exclude cover. Insurers, on the other hand, would wish for a narrow definition of a thing.

When we consider regulation 30, which sets out the exceptions to section 46, we will see that there is a common factor in the exceptions: they tend to apply to insurance relating to machinery. It is most likely a court would find that section 46 applied to physical objects only, because section 46 follows on from the common law position, in which discussion of pre-existing or latent defects always relates to physical objects, and usually to machinery. However, this point is untested in the courts, and an adventurous lawyer or determined insured may be able to convince the court to extend the meaning of the word “thing”.

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<tr>
<th>The exclusions provided by regulation 30?</th>
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<tbody>
<tr>
<td>30 For the purposes of section 46 of the Act, each of the following classes of contracts is declared to be a class of contracts in relation to which that section does not apply:</td>
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<tr>
<td>(a) contracts of insurance commonly known as construction risks insurance contracts;</td>
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<tr>
<td>(b) contracts of insurance commonly known as industrial special risks insurance contracts or commercial risks insurance contracts;</td>
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<tr>
<td>(c) contracts of insurance under which the insurer agrees to indemnify the insured, in relation to a business undertaking, against loss resulting from a breakdown of, or malfunction in, machinery (including electronic equipment) or plant of the insured, being:</td>
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<tr>
<td>(i) loss in respect of the repair or replacement of that machinery or plant; or</td>
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<td>(ii) any further loss resulting from that breakdown or malfunction; or both, but not against any other loss;</td>
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<tr>
<td>(d) contracts of insurance commonly known as products liability insurance contracts;</td>
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9 (1990) 55 SASR 289
contracts of insurance commonly known as “broad form” accidental loss and damage insurance contracts

**What was Parliament’s intention?**

The report of the Australian Law Reform Commission, which was the basis on which the Insurance Contracts Act was drawn up, does not contain any detail relating to the provisions of section 46. Instead, the only clue to Parliament’s intent is found in the second reading speech of the Act. In highlighting important sections of the proposed Act, the then Minister for Trade, Lionel Bowen, said:

> In discussions with the insurance industry, it became apparent that the operation of clauses 46 and 53 may not be appropriate in respect of all types of insurance contract. It may not, for example, be appropriate that an insurer should, under a contract of commercial insurance, be liable under clause 46 for pre-existing defects in materials used by an insured who is a building contractor. The insured may, in those circumstances, have rights to proceed separately against the supplier of faulty goods. ... To take account of these situations, clauses 46 and 53 provide that certain classes of contract may be excluded from the operation of these clauses by the regulation.\(^{10}\)

This paragraph is the only clue to Parliament’s intentions in enacting section 46, and it is not very helpful. The only common threads are that the first two exclusions deal with mechanical defects, and all four exclusions deal with policies which are most likely to be commercial rather than domestic. We note that the example chosen by the Minister in his speech involved a commercial contract, and Professor Sutton also sees the common link as being contracts “having a commercial flavour”.

It could be argued that the insured under a commercial policy will often be in a good position to know of any defects in its equipment or products. In the example of a product liability policy, for example, the insured ought to be aware of the state of its products, and ought to

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\(^{10}\) Commonwealth, *Hansard*, House of Representatives, 29 May 1984, 2333.
have the expertise to recognise any defects. Parliament may have considered that this sort of insured did not need the protection of section 46. Parliament may also have believed that commercial insureds are able to bear the risk of unknown pre-existing defects, whereas individual or domestic insureds do not have the expertise or the financial backing to bear this risk.

However, this is merely speculation until the limits of regulation 30 are tested in court.

The Classes of Policy Excluded under Reg 30

The classes of policy which are included in regulation 30 are fairly straightforward: construction risks, industrial special risks and commercial risks contracts are self-explanatory. However, exclusion (c) is less obvious. It includes policies for repair or replacement of machinery, consequential loss from machinery malfunction. The true purpose of 30(c)(i)(ii) would seem to cover situations of business interruption claims by commercial individuals. Similarly, products liability claims also has the “commercial flavour” as appointed by Sutton. Finally, Section 46 does not apply to broad form accidental loss and damage contracts (see Reg 30(e)).

Broad Form Policy

It is unclear of what type of policy Parliament was referring to when it states "broad form". The Australian and New Zealand Insurance Reporter suggests that the reference to "broad form" accidental loss and damage insurance contracts is a misname since "broad form" contracts primarily exist in liability areas.

It is the writer’s understanding that historically a broad form policy provided a wide range of cover and was not limited to events. The cover provided by a broad form policy was restricted by the exclusion clauses contained in the policy.
Sutton\textsuperscript{11} suggests that "broad form" policies are policies which have been specially negotiated by brokers on behalf of firms and corporations and which are tailored to meet their particular requirements. Usually, there exists general conditions and general exclusions covering the whole of the various types of insurance and these are supplemented by special clauses applicable only to a particular type of risk. Sutton's views on a broad form policy do reflect the intention of Parliament and is not contradictory to the flavour of the Regulations.

That is to say, it is in keeping with the Parliament's intention that the classes to be excluded from the protection of section 46 have a commercial flavour.

\textbf{Onus of Proof}

Notwithstanding the above, the insurer would have the obligation of establishing that the policy in question was a "broad form" accidental loss and damage insurance contract.

\textbf{Section 35 and 37 ICA}

The \textit{Insurance Contracts Act} also imposes duties on insurers to disclose specific terms of the contract. The main aim of section 35\textsuperscript{12} is to ensure that an insurer under a prescribed contract is liable to provide cover against the risks specified in the regulations for at least the amount specified in the regulations.\textsuperscript{13} Section 35 indirectly imposes an obligation on the insurer to clearly inform the insured of a term of the contract of insurance which restricts standard cover.

Similarly, any wording will need to be considered against the requirement of Section 37 of the \textit{Insurance Contracts Act}.

\textsuperscript{11} Sutton, \textit{Insurance Law in Australia}, (3\textsuperscript{rd} edition, LBC) at p 717

\textsuperscript{12} Section 35 of the Act does not apply in relation to interim contracts of insurance (see s38(3) of the Act).

\textsuperscript{13} Standard cover applies in relation to motor vehicle, home buildings, home contents, sickness and accident, consumer credit and travel insurance.
“An insurer may not rely on a provision included in a contract of insurance (not being a prescribed contract) of a kind that is not usually included in contracts of insurance that provide similar insurance cover unless, before the contract was entered into the insurer clearly informed the insured in writing to the effect of the provision (whether by providing the insured with a document containing the provisions, or the relevant provisions, of the proposed contract or otherwise).”

It is likely a number of insurers may have difficulty providing the requisite notices if an insured argues that the exclusion clause was not brought to their attention regardless of Section 46.

Terms altering s46 are void (unless they advantage the insured)

Under section 52 of the Act, any provision which purports to modify the operation of the Act is void, meaning that the insurer cannot avoid the operation of section 46.

Section 52 provides:

“52 "Contracting out" prohibited

(1) Where a provision of a contract of insurance (including a provision that is not set out in the contract but is incorporated in the contract by another provision of the contract) purports to exclude, restrict or modify, or would, but for this subsection, have the effect of excluding, restricting or modifying, to the prejudice of a person other than the insurer, the operation of this Act, the provision is void.

(2) Subsection (1) does not apply to or in relation to a provision the inclusion of which in the contract is expressly authorized by this Act.”

Section 52 makes it clear that an insurer cannot therefore insert a term which has the effect of excluding, restricting or modifying the protection of the Act. Thus, the usual exclusion clauses such as “losses arising from a defect in an item, faulty workmanship, structural defects or faulty design” would be void under section 52.

Section 54 - is it applicable?

Section 54 of the ICA provides:

“54. (1) Subject to this section, where the effect of a contract of insurance would, but for this section, be that the insurer may refuse to pay a claim, either in
whole or in part, by reason of some act of the insured or of some other person, being an act that occurred after the contract was entered into but not being an act in respect of which sub-section (2) applies, the insurer may not refuse to pay the claim by reason only of that act but the insurer's liability in respect of the claim is reduced by the amount that fairly represents the extent to which the insurer's interests were prejudiced as a result of that act.

(2) Subject to the succeeding provisions of this section, where the act could reasonably be regarded as being capable of causing or contributing to a loss in respect of which insurance cover is provided by the contract, the insurer may refuse to pay the claim.

(3) Where the insured proves that no part of the loss that gave rise to the claim was caused by the act, the insurer may not refuse to pay the claim by reason only of the act.

(4) Where the insured proves that some part of the loss that gave rise to the claim was not caused by the act, the insurer may not refuse to pay the claim, so far as it concerns that part of the loss, by reason only of the act.

(5) Where-

(a) the act was necessary to protect the safety of a person or to preserve property; or

(b) it was not reasonably possible for the insured or other person not to do the act,

the insurer may not refuse to pay the claim by reason only of the act.

(6) A reference in this section to an act includes a reference to-

(a) an omission; and

(b) an act or omission that has the effect of altering the state or condition of the subject-matter of the contract or of allowing the state or condition of that subject-matter to alter."

We do not believe Section 54 of the ICA will assist the insured in respect of the matter which may fall under Section 46. The matters to which Section 46 are applicable are pre-contractual. Section 54 deals with matters which are post-contractual. As previously discussed, therefore non-disclosure may be relevant and Section 28 but an insured is unlikely to get any benefits from Section 54 of ICA.

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<th>How to Deal With Claims</th>
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<td>In dealing with claims under Section 46 some basic but practical issues arise including that:</td>
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• Loss Adjusters should communicate with their client before assessing the claim. The type of policy and any relevant exclusion clause should be identified prior to investigating the claim.

• When acting for insurers ensure that it is confirmed in writing that the insured knows you are acting for the insurer and not the insured when investigating the claim. You must from the outset be clear about your role in investigating the claim. Thus, it is important to reserve the insurer’s rights.

• When investigating defect claims loss adjusters should determine:
  • the type of claim being investigated;
  • the type of policy and therefore whether regulation 30 applies;
  • the relevant dates for the loss and relevant date the policy was entered into by the insured;
  • exactly what damage/loss has occurred;
  • the cause of the damage;
  • the evidence to prove the matters set out above including:
    • when was the work/building undertaken/constructed?
    • evidence of when defect arose;
    • is there any evidence which may have brought the defect to the attention of the insured (i.e. building reports)?

• Once the above has been identified, then and only then should an adjuster consider the impact of Section 46.

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14 See *Verson Cleaning v Ward & Partners* (1996) 189 LSJS 135 at 139 per Perry J and *C I Industries Pty Ltd v Keeling* unreported decision of the Supreme Court of New South Wales delivered on 26 March 1997 per Abodee J (BC 9700916).
Conclusion

In Antico Brennan C J discussed the nature of Section 54. Brennan C J stated:

"Section 54 is clearly remedial legislation. Remedial legislation is construed in the manner stated by Mason, Brennan, Deane and Dawson JJ in Khoury v Government Insurance Office (NSW) (1984) 165 CLR 622 at 638"

"the rule[s] that remedial provisions are to be beneficially construed so as to provide the most complete remedy of the situation with which they are intended to deal [by] restrained within the confines of the ‘actual language employed’ and what is ‘fairly open’ on the words used."

The above statement is also applicable in respect of Section 46. Section 46 is remedial legislation provided to protect the insured. Thus, insurers cannot refuse a claim on the basis of a pre-existing defect.

Regulation 30 defines the classes of insurance which will not invoke the protection of Section 46. These polices of insurance have a "commercial flavour" which suggests that domestic policy are not regulated under Regulation 30. In fact, this is consistent with the Act as a whole, which was enacted to ensure that individual consumers were protected and that a fair balance was maintained between the insurers, insured and other members of the public. Only by giving Section 46 an expansive view, and Regulation 30 a narrow view, will a court uphold the intention of Parliament.