UNFAIR CONTRACTS UPDATE

FINANCIAL SECTOR REFORM (HAYNE ROYAL COMMISSION RESPONSE – PROTECTING CONSUMERS (2019 MEASURES)) BILL 2019

Current as at 29 May 2020

EXECUTIVE SUMMARY

UCT changes relevant to insurance

In response to Recommendation 4.7 of the Financial Services Royal Commission, the Government has extended the unfair contract term regime to insurance contracts that are covered by *the Insurance Contracts Act* 1984 (Cth) (**Insurance Contracts Act**) which are also standard form consumer or small business contracts (as defined).

The regime will apply to insurance contracts that are new or renewed (or terms of a pre-existing contract varied) from 5 April 2021. This means insurers and their agents need to reconsider their wordings prior to then. For insurance brokers, their clients will have new rights to challenge terms as being unfair.

The Government has implemented these changes via the Financial Sector Reform (Hayne Royal Commission Response – Protecting Consumers (2019 Measures)) Bill 2019 (Bill) which was passed on 6 Feb 2020. The Bill amends both the *ASIC Act* 2001 (Cth) (**ASIC Act)** and the Insurance Contracts Act. It received Royal Assent on 17 February 2020.

The Bill does not substantively alter the previous exposure draft legislation (see Treasury Laws Amendment (Unfair Terms in Insurance Contracts) Bill 2019 released for consultation on 30 July 2019) beyond specifying that the UCT regime will not be extended to cover medical indemnity insurance contracts.

The changes amend the ASIC Act to tailor the existing UCT regime's application to such insurance contracts as follows:

- **carveout for main subject matter -** previously, terms that define the main subject matter of a contract are exempt from the UCT regime. The ASIC Act has been amended to provide that in relation to insurance contracts only, the main subject matter is limited to the description of what is being insured i.e. it reduced what might otherwise have been excluded as part of the main subject matter.

  Unfortunately for insurers, the new provisions did not adopt the EU approach that had been supported by the insurance industry because it carved out terms which "clearly define or circumscribe the insured risk" since these restrictions are taken into account in calculating the premium paid by the consumer;

- **carveout for transparent excess terms -** terms that set the quantum or existence of the excess or deductible in an insurance contract are exempt from the UCT regime as long as they are presented *transparently*; and

- **third party beneficiary -** third party beneficiaries are allowed to bring actions against insurers under the UCT regime where the contract with the insured otherwise falls within the relevant criteria as explained below.

The Government has not adopted the proposal to change the existing "legitimate interests" qualifier carve out from what it currently is. These changes had been opposed by the insurance industry for practical reasons.

Otherwise, the regime will operate as it currently does for other types of affected contracts (see below for a summary).

The Compliance cost impact statement in the Replacement Explanatory Memorandum (**EM**) surprisingly assesses that compliance costs for insurers are likely to be low. It is estimated that there will be upfront costs of under $4 million in the first year to implement the reform with no ongoing costs for insurers.

UCT consultation on small business extension changes made in 2016 (Small business paper)

In addition to the above, in November 2016, the [Treasury Legislation Amendment (Small Business and Unfair Contract Terms) Act 2015] (the **Act)** extended the UCT protections to small business contracts that meet certain criteria. The Government had agreed at the time to undertake a review of the extension of the UCT regime for small business within two years of its commencement and has released Consultation paper [Enhancements to Unfair Contract Term Protections] as part of this review.

The proposals contained in the consultation paper will affect policies between insurers and insureds as well as standard form contracts between insurance brokers and their customers and others subject to the protections. We note generally where the changes might have application (but not in any detail). A further update will be provided once the proposals are closer to finalisation.

WHAT IS THE EFFECT OF THE UCT CHANGES TO INSURANCE?

Insurance contracts have always been specifically excluded from the UCT regime. The legislation extends the UCT protections to all insurance contracts covered by the Insurance Contracts Act where:

- the contract is a **consumer contract** or **small business contract**;
- the contract is a **standard form contract**; and
- the contract is:
    - a **financial product**; or
    - a **contract for the supply, or possible supply, of services that are financial services.**

The changes aim to prevent insurers from including terms in their standard form contracts that are unfair to the other party. The contract will continue to bind the parties if it is capable of operating without the unfair term.

WHAT ARE CONSUMER AND SMALL BUSINESS CONTRACTS?

A **consumer contract** is a contract where at least one of the parties is an individual whose acquisition of what is supplied under the contract is wholly or predominantly an acquisition for personal, domestic or household use or consumption.

A contract will be a **small business contract** if:

(a) at the time the contract is entered into, at least one party to the contract is a business that employs fewer than 20 persons; and

(b) either of the following applies:

i. the upfront price payable under the contract does not exceed $300,000; or

ii. the contract has a duration of more than 12 months and the upfront price payable under the contract does not exceed $1,000,000.

"**Upfront price**" is the consideration that is provided, or is to be provided, for the supply under the contract, and which is disclosed at or before the time the contract is entered into. However, it does not include any amount that is contingent on the occurrence or non-occurrence of a particular event. Any interest payable under the contract is not to be considered.

In calculating the number of persons a business employs, a head count approach (regardless of an employee's hours or workload) is used. Casual employees are to be counted only if they are employed on a regular or systematic basis, to account for seasonal variations.

Contracts between businesses are excluded from the scope of the unfair contract terms provisions except in respect of 'sole traders'.

These definitions of consumer contract and small business contract are broader than the Insurance Contracts Act Standard covers and Corporations Act Retail client covers and Code Retail insurance definition.

We note that certain types of insurance contracts, including private health insurance contracts, marine insurance, state and Commonwealth government insurance contracts and re-insurance contracts which are not covered by the Insurance Contracts Act will be exempt from the application of these additional amendments. These contracts will be subject to the existing UCT regime without the amendments.

The Small business paper is considering changes to the above definition of small business contract and changes to help clarify the applicable test.

WHAT IS A STANDARD FORM CONTRACT?

A contract is presumed to be standard form unless a party to the proceeding alleges otherwise. In addition to using its discretion in determining whether a contract is a standard form, a court is required to consider:

- whether one of the parties has all or most of the bargaining power relating to the transaction;
- whether the contract was prepared by one party before any discussion relating to the transaction occurred between the parties;
- whether another party was, in effect, required either to accept or reject the terms of the contract in the form in which they were presented;
- whether another party was given an effective opportunity to negotiate the terms of the contract; and
- whether the terms of the contract take into account the specific characteristics of another party or the particular transaction.

An insurance contract will still be a standard form contract even if a consumer can choose between several options such as levels of premium, excess or sum insured, as long as the consumer does not have the ability to negotiate the underlying terms and conditions governing the contract.

Similarly, an insurance contract can still be a standard form contract if it is intermediated by an insurance broker, as long as the circumstances above for determining whether a contract is a standard form contract are met. Examples of what will be considered a standard form contract are provided in the EM.

The Small business paper is proposing changes to better clarify the meaning of ‘standard form contract’.

WHAT IS AN UNFAIR CONTRACT TERM?

A finding by a court that a term is unfair, and therefore void, means that the term is treated as if it never existed. However, the contract will continue to bind the affected parties to the extent that the contract is capable of operating without the unfair term.

A term will be unfair if it:

- would cause a significant imbalance in the parties’ rights and obligations arising under the contract; and
- is not reasonably necessary in order to protect the legitimate interests of the party that would be advantaged by the term; and
- would cause detriment to a party if it were to be applied or relied on.

Before deeming a term unfair, a court is also required to consider:

- the extent to which the contract is transparent – that is, if the term is expressed in reasonably plain language, legible and presented clearly and readily to the party affected by it; and

- the contract as a whole.

In relation to insurance contracts, the EM provides a number of examples of ‘unfair terms’, including:

- *a term that allows the insurer to, instead of making a repair, elect to settle the claim with a cash payment calculated according to the cost of repair to the insurer, rather than how much it would cost the insured to make the repair; or*

- *a term that is an unnecessary barrier to the insured lodging a claim, for example*:
    - *requiring the payment of a large excess before the insurer considers a claim; or*
    - *requiring the insured to lodge the claim within an unreasonably short timeframe.*

The Act also identifies other product-neutral examples of terms that may be unfair. One example is a term that permits, or has the effect of permitting, one party (but not another party) to avoid or limit performance of the contract.

EXEMPTIONS FROM THE REGIME

There are some contracts excluded from the operation of the UCT regime. The only type specifically insurance related is Medical indemnity insurance, which is subject to a separate regulatory regime under the *Medical Indemnity Act* 2002.

A number of terms are exempt from the operation of the UCT regime.

Terms defining the Main subject matter

Terms defining the main subject matter of any financial product or service contract are excluded by the UCT regime to ensure that a party cannot challenge a term concerning the basis for the existence of the contract. This recognises the fact that the party had a choice whether or not to enter the contract on the basis of what was offered.

In relation to insurance contracts, the EM to the Bill states that the main subject matter will be limited to the extent that the term describes what is being insured e.g. the house, car or person that is insured.

The EM notes that this will be determined on a case-by-case basis. It also notes that in relation to insurance contracts that are not property-based, it is expected that only terms that are the basis for the existence of the contract and describe the intangible thing being insured will be considered to be the main subject matter.

The limitation creates a regime that is harsher on insurers than other industries. It creates an unfair playing field. Policy limitations, conditions precedent to cover and exclusions that affect the scope of cover would not be considered part of the 'main subject matter' and would be open to review.

The previous UCT regime left the courts to fairly decide what the main subject matter of a contract is and when the legitimate interests test was met. Courts generally limit main subject matter to those matters central to the consideration that passed between the parties when the contract was formed.

The new provisions implement a narrow limitation which:

- exposes terms which clearly define the insured risk and the insurer’s liability to challenge under the UCT regime;

- is contrary to the position taken for other industries with no justification provided for doing so;

- is inconsistent with the UK and EU and New Zealand where the terms which clearly define or circumscribe the insured risk and the insurer's liability are not caught; and

- makes it virtually impossible for an insurer to safely price its insurance and for reinsurers to do the same. This will increase costs to insureds and affect the type of insurance that can be offered safely.

Terms defining the Upfront price payable

The phrase 'upfront price' is defined as the consideration that is provided, or is to be provided, for the supply under the contract, and which is disclosed at or before the time the contract is entered into. However, it does not include any amount that is contingent on the occurrence or non-occurrence of a particular event. Any interest payable under the contract is not to be considered.

The definition of 'upfront price payable' will apply to insurance contracts, meaning that the insurance premium paid cannot be considered unfair as long as it meets the definition in the ASIC Act. However, 'upfront price payable' does not encompass the excess or deductible of an insurance contract due to the exclusion from the definition of any consideration that is contingent on the occurrence or non-occurrence of a particular event.

Any term required by a law of the Commonwealth or a State Government

Terms required, or expressly permitted, by a law of the Commonwealth or a State or Territory are not covered by the unfair contract terms regime. The EM notes that: *"For insurance contracts, this would include terms defined in the standard cover regime and the definition of 'flood' in regulation 34 of the Insurance Contracts Regulations 2017."*

Transparent terms that set an amount of excess or deductible under the contract

Terms defining the quantum or existence of the excess or deductible of an insurance contract will be excluded from the unfair contract terms regime if they are disclosed upfront and are transparent.

This is because such excesses or deductibles which the insured chooses to increase or decrease would form the basis for the existence of the contract.

For example, a customer may renew an insurance policy, paying a $500 premium. Where a 'basic' excess of $1000 is payable when any claim is made and is clearly presented in the quote and the renewal notice, the *quantum* of the excess ($1000) is not subject to challenge under the UCT regime. Other aspects of the excess term may be.

The small business paper has proposed considering exempting minimum standards included in state and territory laws from the unfair contract terms regime.

COURT DECLARATIONS AND THIRD PARTY BENEFICIARIES

Under the previous UCT regime, a court could only declare that a term is unfair on application by a party to the contract or ASIC.

The new provision provide that third party beneficiaries of insurance contracts (which are not parties to the insurance contract and get their rights under section 48 of the Insurance Contracts Act) have the ability to bring actions against insurers under the UCT regime, as there are circumstances where they will be required to take action in place of the contracting party.

The definitions of consumer and small business and definition of standard form contracts (section 12BK of the ASIC Act) continue to relate to the parties to the insurance contract, not third party beneficiaries. This means that while third party beneficiaries can bring actions, the actions will only be successful if the tests of unfairness and standard form contracts are met with reference to the parties that negotiated the contracts, not the third party beneficiaries.

The small business paper has proposed strengthening enforcement activities by ASIC and regulatory powers due to ongoing concerns that the current regime is not operating effectively as a deterrent to unfair terms being included in small business contracts.

IMPACT OF CHANGES ON INSURANCE CONTRACTS ACT RIGHTS

The Insurance Contracts Act and ASIC Act have been amended to include notes to make it clear that the unfair contract terms regime and the duty of utmost good faith operate independently of one another.

THE END RESULT

Insurers (and their agents) have a lot of work to do prior to 5 April 2021 and this will come at a significant cost and risk, despite what the EM says.

For insurance brokers acting on behalf of a client, this regime is another tool in a consumer's arsenal to get their claim paid. Insurance brokers will need to have an understanding of how it operates in order to properly assist their clients when appropriate.

Expect consumers to want to test an insurer's reliance on the policy terms as an alternative to or in addition to their Insurance Contracts rights. How the various rights under both Acts will interact will be very interesting.