
A Leap of Good Faith:
A Possible Response to Unfair
Claims-Handling Practices in Insurance

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Introduction

Since *Carter v Boehm* in 1766,¹ insurance has been understood as a contract *uberrimae fidei*; that is, each party carries a duty to act in the utmost good faith toward the other. The duty recognises the special nature of the insurance relationship, which at different stages places one party in a vulnerable position, and the other in a position of power. The duty of utmost good faith is intended to even the playing field at these stages.

The claims process demonstrates the inherent power imbalances in the insurance relationship. The insured is likely to be economically and emotionally vulnerable, and relies upon the insurer to assess its claim in a fair and reasonable manner. Conversely, the insurer has significant discretion in its assessment of claims, and financial incentives to limit its liability to the insured. The claims process, then, is a classic example of a situation where the duty of utmost good faith could intervene. However, New Zealand courts have left the enforceability of a claims-handling duty on insurers open.²

Insurers are presently under fire in New Zealand for their handling of Canterbury earthquake claims.³ In particular, concerns have been expressed about unreasonable delays in indemnification,⁴ and insurers taking advantage of the insured's economic weakness by offering deflated settlements.⁵ In light of these issues, the judiciary may soon have to address the enforceability of good faith obligations.

Therefore, this dissertation asks what such a duty would require of insurers during claims-handling, and whether it should be enforceable by the insured. It is largely concerned with first-party insurance arrangements, rather than liability insurance.

Chapter One considers the nature of insurance and the place of the duty of utmost good faith in insurance law. In particular, the content of the duty is examined through the specific obligations it gives rise to. In light of Australian and Canadian law, it is concluded

¹ *Carter v Boehm* (1766) 3 Burr 1905.

² See *Barron v Hutton* HC Auckland CIV-2010-404-7270, 13 September 2011 at [45].

³ Tamsyn Parker "Christchurch backlash predicted for big insurers" *The New Zealand Herald* (online ed, New Zealand, 14 August 2012).

⁴ ONE News "Frustrated homeowners protest in Christchurch" (1 September 2012) Television New Zealand <www.tvnz.co.nz>.

⁵ Diana Clement "Ordeal by insurance: Quake victim's fight for compensation" *The New Zealand Herald* (online ed, New Zealand, 14 September 2012).

that the duty would require insurers to act fairly and reasonably throughout the claims process.

Chapter Two asks to what extent these requirements are already present in New Zealand law. Sources of constraint on insurers include an industry code of practice; consumer protection legislation; existing contractual obligations; and perhaps tort law. However, I demonstrate that these do not satisfactorily address an insurer's bad faith because of content and enforcement issues.

Finally, Chapter Three explores how the duty could be enforced. I argue that it should operate to deter insurers from acting in bad faith, rather than taking a compensatory role. I then consider whether the common law, statute or the industry code of practice should develop to fulfil this deterrent function.

Chapter One

Insurance and the Duty of Utmost Good Faith

I *The Nature of Insurance and Contracts of Insurance*

Contracts of insurance are mechanisms for transferring the risk of a particular loss between two parties. The Insurance (Prudential Supervision) Act 2010 (“IPSA”) recently enacted a licensing regime for insurers and adopted the long-standing definition given by Channell J in *Prudential Insurance Co v Commissioners of Inland Revenue*.⁶ Therefore, a contract of insurance means:⁷

...a contract involving the transference of risk and under which a person (the insurer) agrees, in return for a premium, to pay to or for the account of another person (the policyholder) a sum of money or its equivalent, whether by way of indemnity or otherwise, on the happening of 1 or more uncertain events.

The “uncertain event” must, from the insured’s perspective, have an element of uncertainty as to when or whether it will occur, and must be beyond the insurer’s control.⁸

Insurance spreads the risk of loss through a community. Many individual policy-holders pay sums less than the value of their potential loss, which an insurer pools and distributes to those who suffer loss.⁹ Insurance is viable because the loss of a large group is more predictable than that of an individual, and the few losses covered are generally random and unconnected.¹⁰

II *Insurance as a Contract Uberrimae Fidei (of the Utmost Good Faith)*

Contracts of insurance are subject to the general law of contract. Because the insurance relationship is somewhat unique, however, additional obligations of the utmost good faith have been imposed.

⁶ *Prudential Insurance Co v Commissioners of Inland Revenue* [1906] 2 KB 658 at 664.

⁷ Insurance (Prudential Supervision) Act 2010, s 7(1)(a).

⁸ Section 7(2).

⁹ Craig Brown *Insurance Law in Canada* (7th Student ed, Carswell, Toronto, 2010) at 1-1.

¹⁰ At 1-1.

A *The Origins of the Duty*

Insurance was first considered to be a good faith relationship in 1766 in the English case, *Carter v Boehm*.¹¹ Carter had obtained insurance to cover Fort Marlborough in the event of being taken by foreign forces. The insured event occurred, and Carter claimed for the loss. The insurer argued that the policy was vitiated by fraud as the insured had not disclosed the fort's weakness and the probability of attack. Lord Mansfield held:¹²

Good faith prevents either party by concealing what he privately knows, to draw the other into a bargain, from his ignorance of that fact, and his believing the contrary.

Lord Mansfield stated that the same principle would apply to all contracts. However, the common law preferred the simplicity and certainty of requiring commercial parties to take care of their own interests,¹³ and the principle was confined to insurance contracts. The law developed further after *Carter v Boehm* by extending good faith requirements throughout the life of the contract.¹⁴ Eventually, the Marine Insurance Act 1906 (UK) confirmed that insurance policies required the *utmost* good faith:¹⁵ a standard of “the most extensive, rather than the greatest, good faith”.¹⁶ Through this development, insurance policies became a unique class of contract.

B *Justifications of the Duty of Utmost Good Faith*

The unique treatment of insurance policies is justified by the special and dynamic nature of the relationship. Each party, at different stages, may be placed in a position of vulnerability to the other, and depends on that other to exercise its discretion in a proper manner. Insurers must decide whether to accept another person's personal risk, and on what premium, with little knowledge of that particular risk. It relies upon the insured to disclose pertinent information at this stage, and to not misrepresent claims later on. If that loss occurs, the insured also depends on the insurer to evaluate the claim fairly. Because of this, the law does not see the parties as operating at arms' length from each other as in other contracts.¹⁷ The law must rectify power imbalances produced by the relationship, and promote the reasonable expectations of customers. At the same time, it must preserve the

¹¹ *Carter v Boehm*, above n 1.

¹² At 1910.

¹³ *The Star Sea* at [45].

¹⁴ *K/S Merc-Scandia XXXXII v Lloyd's Underwriters (The Mercandian Continent)* [2001] CLC 1836 at [40].

¹⁵ Marine Insurance Act 1906 (UK), s 17.

¹⁶ *The Star Sea*, above n 13 at [44].

¹⁷ Brown, above n 9, at 1-3.

insurance industry's viability:¹⁸ the costs of doing business must be reasonable and insurers must be able to know where they stand before acting. Mutual obligations of the utmost good faith seek to balance these interests and reduce the parties' vulnerability.

C *The Meaning of "the Utmost Good Faith"*

The "utmost good faith" is inherently vague and incapable of precise definition. What constitutes the utmost good faith will largely depend upon the relevant circumstances,¹⁹ but in a general sense, "good faith" suggests fairness, reasonableness and community standards of fair dealing, decency, and a common ethical sense.²⁰

Good faith must be exhibited "in its *utmost* quality".²¹ This elevated standard is clearly reflected in both parties' pre-contractual disclosure obligations, as they must actively volunteer information which the other party would consider material.²² However, the extended quality of "good faith" is not always apparent; for instance, the insured is only required to be honest when making a claim.²³ So, the extent to which this epithet affects each party's obligations depends upon the relevant context.

Even where the *utmost* good faith is clearly required, the duty is less than a fiduciary one. This is because insurers must be free to protect their own interests.²⁴ This ensures efficiency and also preserves industry viability. If insurers were obligated to prefer the insured's interests in the claims-handling process, this would undermine the bargain the parties had voluntarily assented to. So, in Australia, good faith only requires that each party consider the other's interests equally with their own.²⁵ Fred Hawke states that each party must refrain from exploiting any advantage, power or discretion they hold, but:²⁶

The requirement however stops short of disinterested altruism, and the parties owe each other no more than the level of performance which is reasonably to be expected in light of the contemplated scope and purpose of the policy,

¹⁸ At 1-5-1-6.

¹⁹ *Kelly v New Zealand Insurance Co Ltd* [1996] 130 FLR 97 (WASC) at 111 per Owen J.

²⁰ H K Lücke "Good Faith and Contractual Performance" in P D Finn (ed) *Essays on Contract* (The Law Book Company, Sydney, 1987) 155 at 160.

²¹ *CGU Insurance Ltd v AMP Financial Planning Pty Ltd* [2007] 235 CLR 1 at [176] per Kirby J (his Honour's emphasis).

²² See the discussion below at III and IV.A.

²³ See below at III.

²⁴ *Pegasus Group Ltd v QBE Insurance (International) Ltd* HC Auckland CIV-2006-404-6941, 1 December 2009 at [282], and for Australian authority, see *CGU Workers Compensation (NSW) Ltd v Garcia* [2007] NSWCA 193 at [60].

²⁵ *CGU Insurance Ltd v AMP Financial Planning Pty Ltd*, above n 21 at [15] per Gleeson CJ and Crennan J.

²⁶ Fred Hawke "Utmost good faith: What does it really mean?" (1994) 6(2) *ILJ* 91 at 141-142.

determined by reference to all relevant considerations... Viewed in this light and at the risk of introducing another set of ‘weasel words’ into the debate, utmost good faith can be seen as simply a form of commercial morality.

Parties are expected to act in the utmost good faith throughout the entire insurance relationship, but in New Zealand this is not enforceable as a free-standing, general obligation.²⁷ The so-called “duty” is only enforced through *specific* obligations such as pre-contractual disclosure duties, in order to provide certainty. Neil Campbell has argued that the rationales for specific duties of good faith cannot justify recognition of a generalised duty of good faith,²⁸ and this aligns with the present judicial approach.²⁹ Therefore, the duty of utmost good faith must be explored through its enforceable obligations.

III *The Insured’s Duties of Utmost Good Faith*

“Insurance is a contract upon speculation”.³⁰ With those words in *Carter v Boehm*, a pre-contractual duty of good faith was created to respond to a perceived imbalance between the bargaining parties. The prospective insured is uniquely placed to know of matters which affect the nature, scope and probability of the risk to be transferred. In contrast, the insurer is largely ignorant of such matters and must rely on the insured’s disclosures when deciding whether to accept the risk and on what premium.

This vulnerability necessitates a requirement for positive disclosures by the prospective insured.³¹ Therefore, an absence of misrepresentation is insufficient; an insured must volunteer all past or present facts within his or her personal knowledge, which materially change the relevant risk.³² It is inconsequential that the insurer did not specifically seek the information, although specific questions may modify or waive the duty.³³ Further, the materiality of non-disclosures and misrepresentations is judged from the perspective of a

²⁷ It is useful to note that the Australian duty of utmost good faith *is* a general obligation applying throughout the life of the contract: Insurance Contracts Act 1984 (Cth), s 13. The English duty also appears to be a general one: see *The Mercandian Continent*, above n 14 at [40].

²⁸ Neil Campbell "A Sceptical View of Good Faith in Insurance Law" in Duncan Webb and David Rowe (eds) *Insurance Law: Practice, Policy & Principles* (The Centre for Commercial & Corporate Law, Christchurch, 2004) 205 at 206.

²⁹ *Barron v Hutton*, above n 2 at [44].

³⁰ *Carter v Boehm*, above n 1, at 1909.

³¹ This argument has been challenged because insurers have greater access to information now than when the rule developed due to statistical and information-sharing developments. For an example of this perspective, see Campbell, above n 28 at 206.

³² *State Insurance General Manager v McHale* [1992] 2 NZLR 399 at 409 and 411 per Richardson and Hardie Boys JJ.

³³ *State Insurance General Manager v Peake* [1991] 2 NZLR 287 at 291.

prudent insurer, not the (reasonable) insured.³⁴ Breach can therefore occur innocently.³⁵ So, this rule sees the duty of utmost good faith requiring much more than honesty, and perhaps more than reasonableness as well. It allows an insurer to avoid policies where a misrepresentation or nondisclosure induced its entry into the policy or influenced its terms.³⁶

The duty of good faith also responds to information imbalances when an insured claims against the policy, but applies less harshly. It is essentially an obligation of honesty, and is only breached where the insured party dishonestly omits or misrepresents material information. Breach will allow the insurer to deny the claim.³⁷

The differing requirements at these stages reflects the change in the insurer's vulnerability. The information imbalance is reduced at the claims stage because insurers can investigate particular losses more thoroughly than particular risks. Because of this, it is unnecessary to impose such an onerous duty when an insured makes a claim. It is sufficient that wrongful recovery in cases of fraud is prevented. This demonstrates that the duty's requirements are very much context-dependent and must change as the insurance relationship does.

IV *The Insurer's Present and Potential Duties of Utmost Good Faith*

Whilst it is accepted that insurers owe good faith obligations,³⁸ they apply to insurers with less certainty. The essential question here is whether this apparently mutual duty, which applies so harshly in relation to the insured, can be employed to protect a vulnerable insured as the balance of power in the relationship changes.

³⁴ *State Insurance General Manager v McHale*, above n 32, at 411 per Richardson and Hardie Boys JJ. Both judgments noted that this rule is apt to result in injustice (at 404 per Cooke P) and the 'reasonable assured' test had "much to commend it" (at 415 per Richardson and Hardie Boys JJ). Despite this, the Court of Appeal has more recently stated that the reasonable insurer test was "elementary": *QBE Insurance (International) Ltd v Jaggard* [2007] 2 NZLR 336 at [26]. In misrepresentation cases, the "prudent insurer" test is set out in s 6(2) of the Insurance Law Reform Act 1977.

³⁵ *Carter v Boehm*, above n 1 at 1909.

³⁶ In misrepresentation cases, ss 5-6 of the Insurance Law Reform Act 1977 apply where the insurer's mind was influenced with respect to these matters. In relation to non-disclosure cases, uncertainty was identified (but not resolved) as to whether it is necessary that disclosure would have had a decisive effect, or just any effect at all, on the mind of a prudent insurer: *QBE Insurance (International) Ltd v Jaggard*, above n 34 at [42]. The "decisive effect" test has been rejected in England: *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* [1995] 1 AC 501.

³⁷ *Vermeulen v SIMU Mutual Insurance Association* (1987) 4 ANZ Insurance Cases ¶60-812 (HC) at 74,987; *New Zealand Insurance Co Ltd v Forbes* (1988) 5 ANZ Insurance Cases ¶60-871 at 75,454.

³⁸ *Fussell v Broadbase Christchurch Ltd* HC Christchurch CIV-2009-409-834, 29 June 2011 at [140].

A *Pre-Contractual Disclosure Duties*

The insurer's pre-contractual duty mirrors that of the insured. Prior to entering the insurance policy, insurers must disclose all known material facts with respect to the relevant risk or recoverability of a claim, which a prudent insured would consider in deciding whether to contract with the particular insurer. The insured may avoid the policy and have its premium returned where material non-disclosures induced its entry into the contract.³⁹

Fussell v Broadbase Christchurch Limited may go further. In this case, Associate Judge Osborne declined to strike out a claim that the insurer breached its duty of utmost good faith by underwriting policies which excluded liabilities pertinent to the insured's business.⁴⁰ Thus, it is arguable that including certain terms or exclusions could breach the duty of utmost good faith.

B *Limiting the Exercise of an Insurer's Rights*

An English authority suggests that the duty of good faith may also limit insurers' abilities to exercise their legal rights. In *Drake Insurance Plc v Provident Insurance Plc*,⁴¹ an insurer (Provident) sought to avoid an insurance contract for non-disclosure. The Court of Appeal held that, for lack of inducement, the policy could not be avoided.⁴² In any event and of interest here, Pill LJ stated that the insurer's failure to enquire about the nondisclosure when it was discovered after the contract had been entered into, and to allow the policyholder to respond, breached its duty of good faith. Because of that breach, the insurer could not have avoided the policy.⁴³

New Zealand does not have any similar authority at present. In my opinion, it is doubtful that New Zealand would follow Pill LJ's decision. First, the rule seems (at least partly) motivated by a desire to mitigate the harshness of the non-disclosure rule. This is better

³⁹ *Banque Keyser Ullmann SA v Skandia (UK) Insurance Co Ltd* [1990] 1 QB 665 at 772, not disturbed on appeal in *Banque Financière de la Cité S.A. v Westgate Insurance Co Ltd* [1991] 2 AC 249 at 268. This statement appears to have been adopted in New Zealand: *Fussell v Broadbase Christchurch Ltd*, above n 38 at [142].

⁴⁰ At [160].

⁴¹ *Drake Insurance Plc v Provident Insurance Plc* [2004] QB 601.

⁴² At [63]-[65].

⁴³ At [177]-[178]. The remaining judges were more cautious and did not express a definite view: at [87]-[92] per Rix LJ (stating that Pill LJ's reasoning could become a "recipe for uncertainty and dispute" at [92]) and at [143]-[145] per Clarke LJ.

addressed directly by changing non-disclosure law⁴⁴ rather than limiting an insurer's exercise of legal rights. Secondly, by stating that the duty of utmost good faith is not fiduciary, New Zealand courts have made it clear that insurers must be able to protect their own interests.⁴⁵ *Drake* would conflict with this because "good faith" is vague and the rule could operate unpredictably in this context. It would be difficult for an insurer to ascertain if, and when, it could exercise its legal rights to avoid a policy. This could cause undue cautiousness and inefficient outcomes. Finally, it is difficult to see why gaining knowledge from a later inquiry should cure a defect in the contract's formation.⁴⁶

C *Post-Formation Duties in Liability Insurance*

Under third-party insurance policies, the insurer usually controls settlement negotiations or proceedings taken against the insured. Whilst the insurer and the policy-holder may both be interested in minimising the sum payable, their interests may otherwise conflict. For example, settling may jeopardise the insured's reputation. Because of this, an English decision has limited the insurer's discretion in handling negotiations and proceedings.⁴⁷ In *Groom v Crocker*,⁴⁸ two insurers had agreed to split liability equally between them for two actions. To give effect to this consensus, one insurer instructed its solicitor to admit the insured had been negligent, despite knowing he had not. The Court held the insurer was not entitled to do so. Insurers may select a dispute resolution strategy, but only in what they bona fide consider to be the common interests of themselves and the insured. They cannot be influenced by external advantages and the insurer's action here was "unjustified in point of law as it is assuredly repellent to the sense of business decency".⁴⁹

Although it was not expressly mentioned, this decision is arguably a manifestation of the duty of utmost good faith. An alternative explanation offered by William Young is that the decision is merely a practical response to the unique situation of an insurer acting on the policy-holder's behalf.⁵⁰ However, the latter explanation does not exclude the former; it is because of such unique situations that good faith becomes engaged. The decision seems to

⁴⁴ The law could be changed by, for example, adopting a "prudent insured" test of materiality or a distinction between innocent and fraudulent non-disclosures, although both of these measures could require legislative action.

⁴⁵ *Pegasus Group Ltd v QBE Insurance (International) Ltd*, above n 24 at [282].

⁴⁶ Neil Campbell "Review: Insurance law" (2005) 3 NZ L Rev 431 at 440.

⁴⁷ This decision was apparently approved in *D A Constable Syndicate 386 v Auckland District Law Society* [2010] 3 NZLR 23 at [34].

⁴⁸ *Groom v Crocker* [1939] 1 KB 194.

⁴⁹ At 203-204.

⁵⁰ William Young "Remedies for an insurer's breach of good faith from a New Zealand perspective" (Paper presented at the New Zealand Insurance Law Association Conference, Christchurch, 5 August 2010) at [48], and Campbell, above n 28 at 209.

impose a higher standard on the insurer than would be expected in an arms' length commercial relationship, and protects a vulnerable insured by curtailing the insurer's discretion. This is the function of a duty of good faith. Further, the decision employs language analogous to good faith in its reference to "bona fide" considering the other party's interests and the underlying expectation of "business decency".

The decision in *Groom* is consistent with the duty of utmost good faith being less than fiduciary. Liability insurers can still pursue their own interests, but they should consider the interests and reasonable expectations of the insured. The duty could have similar requirements in the first-party insurance context.

D *A Post-Formation Duty in Handling First-Party Insurance Claims*

In the claims process, insured parties are often emotionally and economically vulnerable. The approval and payment of claims is left in the insurer's hands, so insureds must trust and rely upon insurers to exercise their powers and obligations in a good faith manner. Insurers, on the other hand, are in a position of conflict. They must meet their policy obligations to pay valid claims; but denying or lessening that indemnification is in their financial interests. It is important that insurers strike the correct balance.

A key function of insurance is to provide security, peace of mind and freedom from distress. The spirit and purpose of the contract, then, is curtailed if insurers may act in bad faith whilst handling claims. The insured may be subjected to more emotional or economic harm if, as a result, the insurer falsely denies cover, procures a settlement for substantially less than the true value of the claim, or unreasonably delays payment. The law should protect the vulnerable insured rather than allowing insurers to engage in blameworthy conduct which exploits that position.

The Canterbury earthquakes have stimulated concern about insurers' power and discretion in the claims process. Delayed insurance payments have been particularly controversial, inciting protests⁵¹ and ministerial disapproval.⁵² Some policy-holders had been told to wait

⁵¹ ONE News "Frustrated homeowners protest in Christchurch", above n 4.

⁵² Michael Wright "Brownlee loses patience with insurance companies" (26 July 2012) Stuff <www.stuff.co.nz>.

five years for repairs or rebuilding.⁵³ These problems are compounded by poor communication from insurers.⁵⁴ Recent surveys have found that:

- (i) 49 percent of policy-holders who had filed claims with their insurer were dissatisfied and 17 percent were “extremely dissatisfied”;
- (ii) 78 percent of one insurer’s customers described that insurer’s performance as “poor to awful”;⁵⁵ and
- (iii) Customers of another insurer rated its progress at two out of 10.⁵⁶

There is also anecdotal evidence of insurers treating policy-holders unfairly and offering far less than the true value of their claims.⁵⁷ In some of these instances, policy-holders have felt forced into accepting such offers because of financial need.⁵⁸ Whilst these cases may not necessarily constitute bad faith,⁵⁹ they demonstrate the inherent power imbalances in the insurance relationship and the insured’s dependence on the insurer.

In light of the insurer’s financial incentives to act in bad faith, market forces are an insufficient check on this power imbalance. It would require time and many well-publicised incidents of bad faith to produce a sufficiently poor reputation among potential customers to affect an insurer’s profitability. So, another check is required to ensure that insurers are accountable.

The insurer’s good faith obligations could address this power imbalance and protect the insured in the claims process. However, the ability to enforce a claims-handling duty in New Zealand remains uncertain.⁶⁰ Because of this underdevelopment, I will examine what the “utmost good faith” requires in other jurisdictions before proposing an appropriate duty for New Zealand. The enforceability of this duty will be considered in subsequent chapters.

⁵³ Marta Steeman "IAG, Vero singled out for poor performance" *The Press* (online ed, New Zealand, 2 August 2012)

⁵⁴ Michael Wright "Chch insurers score low in satisfaction survey" *Business Day* (New Zealand, online ed, 11 September 2012).

⁵⁵ Massey University "Insurers rocked by poor earthquake response" (9 August 2012) Scoop Independent News <www.scoop.co.nz>.

⁵⁶ Steeman, above n 53.

⁵⁷ Interview with Colin Macnab, insurance advocate (Jendy Harper, Campbell Live, TV3, 3 September 2012).

⁵⁸ Clement, above n 5.

⁵⁹ Good faith is highly fact-specific, and there may be reasonable expectations for an insurer’s conduct. A finding of bad faith would therefore require a thorough factual inquiry.

⁶⁰ See *Pegasus Group Ltd v QBE Insurance (International) Ltd*, above n 24 at [279] and *Barron v Hutton*, above n 2 at [41].

The Insurance Contracts Act 1984 (Cth) (“ICA”) states that both parties to an insurance contract must act towards each other with the utmost good faith. The ICA does not define “the utmost good faith”, so the common law shapes its content.

Section 13 imposes obligations “of a stringent kind” upon both parties to an insurance contract.⁶¹ The duty was given thorough consideration in *CGU Insurance Ltd v AMP Financial Planning Ltd*. Gleeson CJ and Crennan J stated broadly that s 13 requires insurers to act “consistently with commercial standards of decency and fairness, with due regard to the interests of the insured”.⁶² It would usually require more than passivity and would necessitate positive action from both parties.⁶³ Finally, dishonesty would not be a universal feature of a breach of s 13;⁶⁴ capriciousness and unreasonableness could also suffice.⁶⁵ These ideas are necessarily abstract as the duty’s requirements are context-dependent.

Claims-handling duties under s 13 have been discussed more specifically. In *Moss v Sun Alliance*,⁶⁶ the plaintiffs’ building was destroyed by fire in March 1987. The insurer did not admit liability until February 1988 and made no payments before the trial in 1990. This breached the insurer’s obligation to pay valid claims reasonably promptly, even though there was no ulterior purpose.⁶⁷ Under *CGU v AMP*, insurers must decide in a timely manner so both parties know where they stand and may seek advice.⁶⁸ They cannot reject a claim based on an unjustified and unwarrantable suspicion as to its validity.⁶⁹ They can, however, deny a claim in good faith and put the insured to proof where the claim is suspicious.⁷⁰ This balances the insured’s interest in indemnification with the insurer’s economic interest in not indemnifying excluded or fraudulent claims.

⁶¹ *CGU Insurance Ltd v AMP Financial Planning Pty Ltd*, above n 21 at [178].

⁶² At [15].

⁶³ At [257] per Callinan and Heydon JJ.

⁶⁴ At [130] per Kirby J. Gleeson CJ and Crennan J concurred at [15], as did Callinan and Heydon JJ at [257]. Prior to *CGU v AMP*, the Australian case *Kelly v New Zealand Insurance Co Ltd*, above n 19 at 111-112, had partially adopted the New Zealand decision in *Vermeulen v SIMU Mutual Insurance Association*, above n 37. In the latter case, Hardie Boys J described the (insured’s) duty of good faith as essentially requiring honesty (at 74,987). However, honesty is not sufficient in New Zealand under the pre-contractual duty, as even innocent non-disclosures allow insurers to avoid policies. So, it is preferable to view Hardie Boys J’s comments as confined to the insured’s pre-formation duty.

⁶⁵ *CGU Insurance Ltd v AMP Financial Planning Pty Ltd*, above n 21 at [131].

⁶⁶ *Moss v Sun Alliance Australia Ltd* (1990) 55 SASR 145.

⁶⁷ At 154.

⁶⁸ *CGU Insurance Ltd v AMP Financial Planning Pty Ltd*, above n 21 at [15], [72] and [180].

⁶⁹ *Gutteridge v Commonwealth* (unreported, Supreme Court of Queensland, 25/6/93).

⁷⁰ *CGU Insurance Ltd v AMP Financial Planning Pty Ltd*, above n 21, at [72].

*Gutteridge v Commonwealth*⁷¹ imposed a higher standard, stating that s 13 could be breached even where an insurer “acted honestly although in a blundering or careless fashion”, or was negligent. This duty is similarly onerous to the insured’s pre-contractual obligations. However, it is doubtful that the law goes this far today after *CGU v AMP* stated that s 13 may be breached through dishonesty, unfairness, unreasonableness and capriciousness. This rightly suggests that more blameworthy conduct is required to breach s 13, and provides greater certainty for the boundaries of ‘good faith’ conduct.

Australian authorities should be viewed with caution as the ICA has a consumer-oriented statutory framework,⁷² unlike New Zealand where insurance law is largely common law-based. If the common law is aimed at promoting efficiency, and refraining from interfering in private contractual relations, this may justify taking a different approach to Australia.

2 *The Canadian duty*

The insurer’s post-formation duty in Canada is one of good faith, rather than the *utmost* good faith. However, when compared with Australian authorities, this does not seem to affect its meaning.

As in other jurisdictions, what constitutes good faith is largely circumstance-dependent. Courts must decide each case on its own facts in light of all surrounding circumstances. Hence, it is not possible to develop a closed category of defining features of good faith.⁷³

However, principles have developed to shape the meaning of “utmost good faith”. Under *702535 Ontario Inc v Non-Marine Underwriters Members of Lloyd’s London*,⁷⁴ the two central obligations of insurers are to act promptly and fairly, throughout the investigation, assessment and resolution of claims.⁷⁵

The timeliness requirement exists to protect insured parties who are under considerable financial pressure to settle claims as soon as possible, and may be disadvantaged even if

⁷¹ *Gutteridge v Commonwealth*, above n 69.

⁷² The ICA has made a number of changes to the common law to favour the insured’s interests. For instance, the materiality of an insured’s non-disclosure is viewed from the insured’s perspective (s 21(1)), and insurers can no longer avoid policies for innocent non-disclosures (s 28(2)). Further, parties cannot rely on provisions of policies where to do so would show a want of good faith (s 14) and the ICA has introduced limits on an insurer’s ability to refuse to pay claims in certain circumstances (s 54).

⁷³ *McDonald v Insurance Corp of British Columbia* (2012) BCSC 283 at [188].

⁷⁴ *702535 Ontario Inc v Non-Marine Underwriters Members of Lloyd’s London* (2000), 184 DLR (4th) 687 (ONCA), approved by the Supreme Court of Canada in *Fidler v Sun Life Assurance Co of Canada* (2006) SCC 30.

⁷⁵ *702535 Ontario Inc v Non-Marine Underwriters Members of Lloyd’s London*, above n 74, at [27].

insurers pay interest on delayed claims.⁷⁶ Insurers have breached this requirement by failing to investigate claims promptly and efficiently,⁷⁷ and for failing to pay promptly. In one case, an insurer failed to pay different parts of a claim until 10 months and almost four years, respectively, after the event which caused the loss.⁷⁸

The fairness requirement was succinctly summarised by O'Connor JA in *702535 Ontario*.⁷⁹

[A]n insurer must assess the merits of the claim in a balanced and reasonable manner. It must not deny coverage or delay payment in order to take advantage of the insured's economic vulnerability or to gain bargaining leverage in negotiating a settlement. A decision by an insurer to refuse payment should be based on a reasonable interpretation of its obligations under the policy. This duty of fairness, however, does not require that an insurer necessarily be correct in making a decision to dispute its obligation to pay a claim. Mere denial of a claim that ultimately succeeds is not, in itself, an act of bad faith: *Palmer v. Royal Insurance Co. of Canada* (1995), 27 C.C.L.I. (2d) 249 (O.C.G.D.).

As in Australia, fraud or corrupt motives need not be present to breach the duty.⁸⁰

Insurers have breached the fairness requirement by using inadequate evidence to deny claims.⁸¹ In *McDonald v Insurance Corporation of British Columbia*, the insurer decided that the insured had breached its policy in reliance on evidence which plainly required further investigation.⁸² Insurers may deny claims on reasonable legal and factual bases,⁸³ and need not have “iron-clad” evidence; but insurers must exercise reasonable diligence, fairness, appropriate skill and thoroughness in investigating and assessing claims.⁸⁴

The standard is also breached where an insurer disregards evidence which favours accepting the claim. In *Wilson v Saskatchewan Government Insurance*, the insurer terminated a health and disability benefit but failed to interview the insured and did not review medical

⁷⁶ At [28].

⁷⁷ *Perrett v Canadian Direct Insurance Inc* [2007] BCPC 23 at [15] and *Cornhill Insurance v Sphere Drake Insurance* [2006] NLCA 56 at [164].

⁷⁸ *Ferme Gerard Laplante & Fils Ltee v Grenville Mutual Fire Insurance Co* (2002) 61 OR (3d) 481 at [86].

⁷⁹ *702535 Ontario Inc v Non-Marine Underwriters Members of Lloyd's London*, above n 74 at [29].

⁸⁰ *McDonald v Insurance Corp of British Columbia*, above n 73 at [189].

⁸¹ See *Asselstine v Manufacturers Life Insurance Co* [2005] BCCA 292 and *Kogan v Chubb Insurance Co of Canada* (2001) 27 CCLI (3d) 16 (Ont SCJ) where insurers have acted in bad faith by disregarding pertinent information and placing undue emphasis on unreliable and incomplete evidence.

⁸² *McDonald v Insurance Corp of British Columbia*, above n 73 at [227] and [238].

⁸³ *Veno v United General Insurance Corporation* [2008] NBCA 39 at [86].

⁸⁴ *McDonald v Insurance Corp of British Columbia*, above n 73, at [249].

opinions.⁸⁵ It relied completely on one consultant's opinion, despite overwhelming evidence to the contrary. This breached the requirements of fairness, objectivity and even-handedness in investigating and evaluating claims.⁸⁶

Finally, in *Whiten v Pilot Insurance*, an insurer breached the duty by maintaining an untenable defence and manipulating witnesses. The facts of this case are compelling. The insured's house burned down, and she lost all of her possessions and several pets. The insured's husband suffered frostbite and was temporarily wheelchair-bound. Notwithstanding these facts and the contrary views of several investigators, the insurer decided the fire was deliberately lit and terminated the insured's living expenses without notice. The insurer's lawyers convinced an expert to change his views, and gave misleading information to experts. In the course of litigation, the insurer admitted it had no grounds to suspect arson. This was a clear breach of good faith.

3 *What should the utmost good faith require?*

So far, no New Zealand cases have necessitated a definitive statement of a claims-handling duty of good faith. Insureds have argued that insurers have breached their good faith obligations by delaying claims⁸⁷ and engaging in poor quality decision-making processes involving elements of pre-determination.⁸⁸ It has also been argued that an insurer acted in bad faith in identifying the nature and cause of damage, and the extent of consequential losses.⁸⁹ As in Australia and Canada, the duty of utmost good faith should be applicable in all of these instances. This is because insurers have significant discretion throughout the process, especially when investigating claims. So, the duty of utmost good faith should have a broad role across all stages of claims-handling, including the investigation, assessment and settlement of claims.

The content of this obligation could be conceptualised in two ways. The first view is that the duty should entail broad and flexible requirements of reasonableness and fairness. This

⁸⁵ *Wilson v Saskatchewan Government Insurance* [2010] SKQB 211.

⁸⁶ At [130].

⁸⁷ *State Insurance Ltd v Cedenco Foods Ltd* CA216/97, 6 August 1998 and *Pegasus Group Ltd v QBE Insurance (International) Ltd*, above n 24.

⁸⁸ *Pegasus Group Ltd v QBE Insurance (International) Ltd*, above n 24. Winkelmann J found at [279] that the insurer engaged in a slow response and poor quality decision-making, but did not find any predetermination in that case.

⁸⁹ *Barron v Hutton*, above n 2. In particular, issues had arisen between the parties as to whether the Barrons' house was contaminated with a harmful substance, and what steps were required to make it habitable. The Barrons were denied indemnity for reduced life expectancies and care costs, which was found to be justified at [30]-[34] because of the bar under the Accident Compensation Act 2001, but the bad faith claim was not struck out as the grounds were broader than this (although not specifically articulated in the case).

is the prevailing law in Australia and Canada, and the duty has not required an unreasonably high standard of conduct from insurers in those jurisdictions. The Law Commission for England and Wales and the Scottish Law Commission have advocated a similar duty,⁹⁰ and this view is also supported by obiter statements in New Zealand. In *State Insurance Ltd v Cedenco Foods Ltd*, Salmon J in the High Court favoured a wide duty requiring fairness, reasonableness, decency and fair dealing.⁹¹ In the Court of Appeal, the main judgment did not consider the duty's content, but Thomas J "assumed" it would require insurers to act conscientiously, fairly and reasonably.⁹²

This standard reflects the spirit of the concept of utmost good faith and could capture a wide range of blameworthy conduct. It would also have useful similarity to the duties of liability insurers.⁹³ The standard is flexible but in light of the Canadian and Australian law, insurers could be required to:

- (i) Investigate claims fairly and reasonably quickly;
- (ii) Assess claims fairly, objectively and even-handedly, with consideration of all relevant circumstances but no irrelevant matters;
- (iii) Decide whether to accept the claim within a reasonable time, and only deny claims on reasonable grounds;
- (iv) Reach settlements fairly, without taking advantage of the insurer's economic weight or the insured's vulnerability; and
- (v) Pay valid claims within a reasonable period.

The second view is that good faith should only require honesty. Insurers have advanced this view in *Cedenco Foods* and in *Pegasus Group Ltd v QBE Insurance (International) Ltd*.⁹⁴ This would provide parity in the parties' post-formation obligations. However, as the duty of utmost good faith is only expressed through specific, independent obligations, these duties need not have the same content.

⁹⁰ Law Commission for England and Wales and Scottish Law Commission *Issues Paper 6: Damages for late payment and the insurer's duty of good faith* (2010) at [9.18].

⁹¹ *Cedenco Foods Ltd v State Insurance Ltd* (1997) 6 NZBLC 102,220 (HC) at 102,234.

⁹² *State Insurance Ltd v Cedenco Foods Ltd*, above n 87 (CA).

⁹³ See above at IV.C.

⁹⁴ *Pegasus Group Ltd v QBE Insurance (International) Ltd*, above n 24.

A touchstone of honesty could provide useful certainty for insurance practice and litigation. However, the insurer in *Pegasus* conceded that enough capriciousness or unreasonableness could conceivably amount to dishonesty.⁹⁵ Although Winkelmann J did not decide this point, this concession was rightly made. The main difference between the two conceptions of good faith would be the threshold for conduct to be acceptable, with honesty comprising a lower standard than reasonableness or fairness.

An honesty standard could be too restrictive and difficult to prove. Insurers have monetary incentives to take advantage of the insured's vulnerability, and sufficient discretion and economic weight to do so. Conversely, the insured party may be economically and emotionally vulnerable, and relies on the insurer to protect its interests. Because of this, it is justifiable to expect more of insurers than honesty. A standard of reasonableness and fairness strikes an appropriate balance between protecting the insured and promoting an efficient insurance industry. Insurers would be required to consider the insured's interests, but they need not expend excessive costs or time in investigating claims. They must follow due process in handling claims, but are still free to deny or delay claims on a reasonable basis. Therefore, the remainder of this paper considers a good faith duty of fairness and reasonableness in claims-handling.

V *Conclusion*

The mutual duty of utmost good faith was developed to facilitate the operation of insurance and even the playing field between the parties at times of vulnerability. The concept is "better described than defined",⁹⁶ but I contend that insurers should owe duties of fairness and reasonableness during the claims process. Given that a purpose of insurance is to provide security and peace of mind for the insured, it is arguable that those obligations should become enforceable. This could protect the interests of the insured and constrain abuses of the insurer's power. The following Chapters examine present controls on claims-handling practices and possible options for reform.

⁹⁵ At [264].

⁹⁶ Callan O'Neill "A pot of gold? The unfinished story of utmost good faith and the Insurance Contracts Act" (2008) 19 ILJ 245 at 14.

Chapter Two

Existing Constraints on Claims-Handling Practices

I *Introduction*

To examine whether the law should enforce a specific duty of the utmost good faith on insurers in claims-handling, it is necessary to clarify the extent to which duties of fairness and reasonableness are already recognised. As Campbell has stated, any development should be “with a close eye on the rest of private law”.⁹⁷ Many sources may constrain an insurer’s claims-handling practices, including an industry code of practice, statutes, contract law and perhaps tort law. However, as I will demonstrate, the content and enforcement of these obligations are insufficient to address the problem of bad faith.

II *Industry Self-Regulation through the Fair Insurance Code*

The Fair Insurance Code (“FIC”) is an industry code of practice administered by the Insurance Council of New Zealand (“ICNZ”).⁹⁸ ICNZ is an industry representative body, and approximately 95 percent of New Zealand’s general insurance is underwritten by its members.⁹⁹

The FIC sets service standards for insurers. It first provides a general standard, requiring insurers to act “fairly and openly” in all dealings with customers; but this standard is explicated only through duties to keep the insured informed. If this obligation only requires disclosures, it will not address bad faith in the claims-handling context; although openness in that process may reduce the insured’s sense of vulnerability.

In claims-handling, insurers have specific obligations to explain the process, give progress updates and explain their decisions. More significantly, valid claims must be settled quickly and fairly. Despite its brevity, the latter obligation broadly reflects the good faith requirements of fairness, reasonableness and timeliness in claims-handling, and impresses high-level expectations of insurers’ conduct.

⁹⁷ Campbell, above n 28 at 215.

⁹⁸ Insurance Council of New Zealand "The Fair Insurance Code" <www.icnz.org.nz>.

⁹⁹ See Insurance Council of New Zealand "ICNZ Members" <www.icnz.org.nz> and the Fair Insurance Code, above n 98.

The FIC shows that (most) insurers consider themselves to be bound by good faith duties throughout the claims process. So, good faith obligations may already influence insurers' conduct when dealing with customers and claims. The main limitation of the content of these obligations is that, on a strict view, they may not apply to invalid claims.¹⁰⁰ If an insurer has kept the insured informed when handling an invalid claim, inadequate or unfair processes may be acceptable under the FIC. The duty of utmost good faith, however, would apply to claims-handling practices irrespective of a claim's validity.

The greater issue is one of enforcement. The FIC refers aggrieved customers to their insurer's dispute resolution scheme, which is usually the Insurance and Savings Ombudsman scheme ("ISO").¹⁰¹ However, the ISO only investigates where the insurer's internal complaint mechanisms cannot resolve the dispute.¹⁰² This gives insurers considerable scope to settle and avoid ISO intervention. This is problematic as insureds may have lesser bargaining power or understanding of their rights. Moreover, the disputed part of the relevant claim must be worth \$200,000 or less;¹⁰³ so the ISO is not accessible for large commercial insureds or where the subject matter of a claim is a total or otherwise significant loss of a large asset, like a family home. In contrast, a duty of utmost good faith would recognise that even commercial insureds may be vulnerable in the claims-handling process (economically rather emotionally). They too would be protected. So, as the ISO only deals with a narrow range of insurance disputes, its ability to identify and deter bad faith (particularly in its systemic form) is correspondingly limited.

The ISO may consider complaints of a breach of the FIC,¹⁰⁴ and shall have regard to the FIC in deciding a fair and reasonable outcome for a dispute.¹⁰⁵ However, the ISO has not engaged with these responsibilities. It has only once found a breach of the FIC in claims-handling.¹⁰⁶ In other claims-handling disputes, ISO case managers have advised the insured to pursue potential breaches through ICNZ.¹⁰⁷ This may be because the ISO is designed to

¹⁰⁰ That is, claims which are excluded or otherwise not covered under the insurance policy.

¹⁰¹ All insurers in New Zealand must belong to an approved dispute resolution scheme under the Financial Service Providers (Registration and Dispute Resolution) Act 2008, s 48.

¹⁰² Insurance and Savings Ombudsman Scheme "Terms of Reference" (1 March 2012) <www.iombudsman.org.nz>, cls 8.1-8.2.

¹⁰³ Clauses 1.1 ("applicable monetary limit") and 5.2. The value excludes GST.

¹⁰⁴ Clause 5.1(c).

¹⁰⁵ Clause 12.2(d).

¹⁰⁶ Insurance and Savings Ombudsman "Complaint No 108599" (2000) <www.iombudsman.org.nz>.

¹⁰⁷ Insurance and Savings Ombudsman "Complaint No 110117" (2004) <www.iombudsman.org.nz>; Insurance and Savings Ombudsman "Complaint No 110739" (2004) <www.iombudsman.org.nz>; Insurance and Savings Ombudsman "Complaint No 111540" (2006) <www.iombudsman.org.nz>.

resolve disputes, and it need not consider the quality of an insurer's conduct to fulfil that purpose.

Thus, whilst the FIC refers complainants to the ISO, the ISO refers them back to ICNZ. ICNZ may not be an appropriate body to manage complaints as it would hold the dual roles of "policeman and friend".¹⁰⁸ That is, ICNZ's role as an industry-representative body may conflict with its interests in protecting customers. Moreover, ICNZ would ensure the complaint is fully investigated by someone not involved in the original decision. Reverting to the insurer's internal complaints mechanisms may not provide the external enforcement necessary to censure and to deter bad faith.

Finally, if the ISO identifies a breach or possible breach of the FIC, it can take three possible actions.¹⁰⁹ First, it may advise the insurer of that finding. However, this simple, private disapproval may not sufficiently counter the monetary incentive to act in bad faith. Second, the ISO may notify the Minister responsible for the Financial Service Providers (Registration and Dispute Resolution) Act 2008 ("FSPA"), the Financial Markets Authority or another regulator. Unless public attention is brought to the issue, this may also be ineffective, because the existing statutory regimes do not provide any relevant sanctions.

The FSPA does not contain any penalties for blameworthy conduct by financial service providers.¹¹⁰ The licensing regime under IPSA also does not contain sanctions which allow bad faith or other blameworthy conduct to affect an insurer's licensed status.¹¹¹

Another relevant statute is the Financial Advisers Act 2008 ("FAA"), which regulates the provision of financial adviser services. An insurer provides financial adviser services if, in the ordinary course of business, it makes recommendations or gives opinions in relation to acquiring or disposing of insurance.¹¹² To provide this advice,¹¹³ an insurer would normally constitute a qualifying financial entity ("QFE"), and its employees would be QFE advisers.¹¹⁴ Some employees may also be authorised financial advisers ("AFAs"). QFEs and advisers can only be disciplined in relation to the provision of financial adviser

¹⁰⁸ E-DEC Limited "Purposes, Functions and Structure of Law Societies in New Zealand" (Final Report to the New Zealand Law Society, Wellington, 1997) at 8, in the separate context of Law Societies.

¹⁰⁹ Insurance and Savings Ombudsman Scheme "Terms of Reference", above n 102, clause 17.2.

¹¹⁰ The grounds for deregistration are set out in s 18 of the Act, and do not refer to the financial service provider's conduct.

¹¹¹ See s 30 for the grounds to cancel an insurer's licence.

¹¹² Financial Advisers Act 2008, ss 9-10. The s 5 definition of a "financial product" includes "category 2 products, which in turn includes contracts of insurance.

¹¹³ See ss 16-20.

¹¹⁴ See "QFE adviser" in s 5.

services.¹¹⁵ Therefore, unless public attention is drawn through the ISO's referral to a regulator, bad faith is unlikely to be addressed through this route.

Third, the ISO may "take other such action it considers appropriate including to determine whether a broader issue exists that warrants remedial action". Again, this is quite distinct from the ISO's role of dispute resolution, which does not necessitate consideration of the quality of an insurer's conduct. It could be workable, but the ISO receives little guidance on what actions (and subsequent remedial actions) could be "appropriate". Further, the limited scope of disputes that the ISO manages means its view of an insurer's conduct, and its potentially systemic nature, is necessarily limited.

The FIC is significant for demonstrating that insurers accept obligations of good faith in claims-handling; but its limited and inadequate enforcement mechanisms make it an ineffective tool for dealing with bad faith. However, the self-imposition of these obligations gives a greater mandate for legal recognition and enforcement of similar duties.

III *Statutory Obligations*

Two statutes which could constrain insurers' conduct during claims-handling are the Consumer Guarantees Act 1993 and the Fair Trading Act 1986.

A *Consumer Guarantees Act 1993*

The Consumer Guarantees Act ("CGA") imposes extensive duties on insurers when they provide rights or benefits under a contract of insurance to a consumer.¹¹⁶ The insurer guarantees it will carry out those services with reasonable care and skill,¹¹⁷ and, where no period is fixed, within a reasonable time.¹¹⁸ An insurance contract necessarily entails a right to the assessment of claims and indemnification of valid claims, so the insurer effectively carries a duty of care in this process under the CGA.

These duties are broadly similar to good faith requirements. The timeliness obligation mirrors that of the duty of utmost good faith. However, taking reasonable care is not the same thing as acting fairly toward an insured. A duty of care obligates a certain quality of

¹¹⁵ See, for example, s 34, 47 and 130. For AFAs, see also Code Standards 1, 2 and 6 of the Financial Advisers (Code of Professional Conduct for Authorised Financial Advisers) Notice 2010.

¹¹⁶ Section 2 of the Consumer Guarantees Act 1993 defines "services" to include the rights, benefits or privileges that are, or are to be, provided or conferred by a supplier under a contract of insurance; and "supplier" includes a person who, in trade, supplies services to an individual consumer or group of consumers.

¹¹⁷ Section 28.

¹¹⁸ Section 30.

performance and imposes an objective standard on insurers.¹¹⁹ It may necessitate some fair practices but that is merely a by-product of that obligation. In contrast, the duty of good faith is concerned with the quality of an insurer's *conduct* and the subjective intention or recklessness behind it. It concerns the relationship with the insured, not just the relevant task. In particular, a duty of good faith requires consideration of the insured's interests, whereas the CGA may not. So, these duties are fundamentally distinct.

Second, the CGA only applies in the consumer context. As explained above,¹²⁰ the duty of utmost good faith would recognise the vulnerability of commercial insureds and offer corresponding protection.

If an insurer fails to comply with a guarantee, the consumer may require the insurer to remedy it within a reasonable time,¹²¹ or cancel the contract.¹²² The consumer may also seek damages for reasonably foreseeable losses caused by the failure.¹²³ Cancellation would not address the relevant harms of a failure to take reasonable care in the insurance context, and the other remedies probably reflect the existing contractual remedies.¹²⁴ So, the remedies under the CGA cannot function to deter bad faith.

B *Fair Trading Act 1986*

Unlike the CGA, the Fair Trading Act ("FTA") contains prohibitive provisions relating to an insurer's conduct rather than its performance of contractual obligations. The FTA provides that insurers must not, in trade, engage in conduct which is likely to be misleading or deceptive.¹²⁵ Further, they must not make false or misleading misrepresentations about the existence, exclusion or effect of any condition, right or remedy under a contract of insurance.¹²⁶ If these obligations are breached, insurers may be liable for any loss or damage caused, including damages for emotional distress.¹²⁷

¹¹⁹ Melvin A Eisenberg "The Duty of Good Faith in Corporate Law" (2006) 31 Del J Corp L 1 at 30 cites this as the fundamental differences between duties of care and duties of good faith. The former is fundamentally concerned with a promise to perform; the latter is not.

¹²⁰ See the discussion of the Fair Insurance Code at II.

¹²¹ Section 32(a)(i).

¹²² The consumer may only cancel the contract where an insurer has refused or neglected to remedy its failure under s 32(a)(ii)(B), or, under s 32(b)(i), the failure is of a substantial character under s 36.

¹²³ Section 32(c)

¹²⁴ See below at IV.B.

¹²⁵ Fair Trading Act 1986, s 9. Note that "trade" is defined to include any business relating to the supply of "services", which expressly includes the rights, benefits and privileges to be provided under a contract of insurance (s 2).

¹²⁶ Section 13(i).

¹²⁷ Section 43 and see *Smythe v Bayleys Real Estate Ltd* (1994) ANZ ConvR 424.

In the insurance context, these provisions are usually applied in pre-contractual matters,¹²⁸ but the FTA extends to claims-handling as “trade” is broadly defined.¹²⁹ Because the FTA’s provisions are conduct-based rather than performance-based, they have some overlap with the duty of good faith. Deliberately misleading or deceiving an insured is a classic breach of both rules. In some respects, the FTA requires more than good faith because it may be breached even in the absence of intent, dishonesty and unreasonableness.¹³⁰ However, a duty of good faith is much more comprehensive a much wider range of behaviour may constitute bad faith. Therefore, the FTA does not perform the substantive role of a good faith obligation.

IV *Contractual Obligations*

An insurance contract could include express obligations for the insurer to act in good faith when handling claims. However, given commercial realities and their desire for certainty, insurers are unlikely to bind themselves to onerous and flexible conduct obligations of that kind in contract. At present, the courts have not implied such a duty either.¹³¹ However, the existing contractual obligations of insurers may overlap with that duty.

A *Contractual Obligations of Indemnification and Timeliness*

Every contract of insurance gives the insured an enforceable right to the payment of a valid claim. This obligation may be breached whether an insurer has acted in good or bad faith, as denial of a subsequently successful claim is not always a result of unfairness or unreasonableness.¹³²

Insurance policies also obligate insurers to pay valid claims within a reasonable time, either expressly or impliedly.¹³³ This contractual duty therefore fulfils the timeliness role of the duty of utmost good faith.

These existing duties (and their associated remedies) made it unnecessary to address the enforceability of good faith obligations on the particular facts in *Pegasus Group Ltd v QBE Insurance (International) Ltd*.¹³⁴

¹²⁸ See, for example, *Clifton-Mogg v National Bank of New Zealand Ltd* (2001) 10 TCLR 213.

¹²⁹ See above n 125. No relevant cases seem to have arisen in the claims-handling context thus far.

¹³⁰ *Bloor v LAG New Zealand Ltd* HC Rotorua CIV-2004-463-425, 19 March 2010 at [126].

¹³¹ The most recent decision to leave this question open is *Barron v Hutton*, above n 2. The possibility of implying a duty of utmost good faith is explored further in Chapter 3.

¹³² 702535 *Ontario Inc v Non-Marine Underwriters Members of Lloyd's London*, above n 74 at [29].

¹³³ In *Cedenco Foods Ltd v State Insurance Ltd*, above n 91 (HC), the defendant insurer conceded that a court could imply a timeliness duty, and given that consequential losses may be awarded to compensate for delays under *New Zealand Insurance Co Ltd v Harris* [1990] 1 NZLR 10.

The conduct of QBE prior to the commencement of proceedings can generally be described as involving a slow response and ultimately a poor quality decision making process. But to say that is really to say nothing more than that QBE was in breach of contract. Pegasus has its remedy for that.

However, good faith is far more extensive than the existing contractual duties. It would, for instance, require an insurer to investigate a claim fairly and reasonably, and to refrain from using its economic weight against the insured in settlements. It is true that in some cases, unfairness could cause a contractual breach through the non-payment or delayed payment of a valid claim. However, as I will show,¹³⁵ remedying the breach of contract does not address the problem of bad faith.

Further, good faith duties are fundamentally different from ordinary contractual obligations. They are not about performance, and preventing loss should not be a principal concern of their enforcement. Rather, good faith obligations are concerned with protection of vulnerable parties by requiring a certain quality of conduct from a powerful party. Because of this, the obligation would apply irrespective of a particular claim's validity, even if an absence of loss meant it would not be enforced.

B *Remedies for Breach of the Existing Contractual Obligations*

The question here is whether the remedies for breaches of the existing contractual terms enable the recognition of bad faith in forms other than unreasonable delays. In a non-payment or delayed payment case, an insured may sue for the value of its valid claim with interest for delay. Damages for consequential losses and mental distress may compensate for the additional harms of the breach of contract. However, it seems that any bad faith which causes that breach is largely inconsequential.

Consequential losses are recoverable if both parties, at the time of entering the insurance policy, would reasonably have contemplated those particular losses as natural or probable consequences of the particular breach.¹³⁶ Such damages can be extensive, particularly where a failure to pay results in the loss of a home or business.¹³⁷

¹³⁴ *Pegasus Group Ltd v QBE Insurance (International) Ltd*, above n 24 at [279].

¹³⁵ See IV.B.

¹³⁶ *Hadley v Baxendale* (1854) 9 Ex 341 at 354.

¹³⁷ For example, see *Monkley v Guardian Royal Exchange Assurance of New Zealand Ltd* HC Hamilton CP209/88, 23 August 1990. For other insurance cases in which consequential losses were recoverable, see *Bloor v LAG New Zealand Ltd*, above n 130; *New Zealand Insurance Co Ltd v Harris*, above n 133; and *Stuart v Guardian Royal Exchange Assurance of New Zealand Ltd* (1988) 5 ANZ Insurance Cases ¶75,274.

Damages can also be obtained for the mental consequences of an insurer's breach of contract.¹³⁸ On entering the contract, the particular distress or inconvenience suffered must have been the reasonable contemplation of the parties in the event of breach.¹³⁹ Because this test focuses on the actual breach, on a strict view, courts should not consider the bad faith which led to that breach when they quantify general damages.

Where bad faith in the claims process has caused a wrongful non-payment or delayed payment of a valid claim, these contractual remedies will compensate for those latter wrongs. An enforceable duty of good faith would be unlikely to provide any additional compensation. Even where contractual duties are not owed because a claim is excluded by the relevant policy, any bad faith in handling that claim would be unlikely to result in any foreseeable loss under *Hadley v Baxendale*.¹⁴⁰

However, the role of good faith is not already fulfilled by the contractual remedies, as they do not address the additional wrong of dishonesty, unreasonableness and fairness which accompanies the contractual breach. If an insurer acts in bad faith in handling some claims, it may still profit from doing so where significant consequential losses are not foreseeable, and if only a small proportion of insureds take action. So, the incentives for bad faith persist.

Exemplary damages are designed to punish, denounce and deter blameworthy conduct in cases where compensation alone cannot accomplish this.¹⁴¹ These damages could be an appropriate mechanism to address any bad faith accompanying a breach of contract. However, the Court of Appeal has held that this remedy is not available for breaches of contract.¹⁴² This decision is firmly expressed and therefore future cases are unlikely to depart from it. So, courts will not take the insurer's bad faith into account at any stage of an ordinary contractual case.¹⁴³

¹³⁸ The following cases are examples of awards of general damages. The awards are generally modest and tend to vary with the value of the claim. In *Edwards v AA Mutual Insurance Company* (1985) 3 ANZ Insurance Cases ¶60-668, \$2000 was recovered for the mental consequences of non-payment of a claim worth \$42,000. In *Stuart v Guardian Royal Exchange Assurance of New Zealand Ltd*, above n 137, \$4000 was awarded in relation to a claim on a home insured for \$80,000. In *Monkley v Guardian Royal Exchange Assurance of New Zealand Ltd*, above n 137, the award was calculated at \$10 per day (adding to a total of \$16,740) in relation to a claim worth approximately \$134,000. Finally, \$10,000 was awarded more recently in *Bloor v LAG New Zealand Ltd*, above n 130, in relation to claims worth approximately \$145,000 plus GST.

¹³⁹ *Monkley v Guardian Royal Exchange Assurance of New Zealand Ltd*, above n 137.

¹⁴⁰ *Hadley v Baxendale*, above n 136.

¹⁴¹ *Couch v Attorney-General* [2010] 3 NZLR 149 at [58].

¹⁴² *Paper Reclaim Ltd v Aotearoa International Ltd* [2006] 3 NZLR 188.

¹⁴³ The exception is in health and disability insurance where, if an insurer denied a claim unreasonably or in bad faith, the Court can substitute its own finding for the insurer's. See, for example, *Cigna Life Insurance NZ*

Therefore, aside from the timeliness obligation, the wider duty of utmost good faith is not recognised through the content of the existing contractual obligations or their judicial enforcement. Bad faith may not be effectively deterred by the insurance contract alone.

V *Tortious Obligations*

No direct authority has addressed whether insurers owe tortious duties of care in the claims process under the law of negligence. In *South Pacific Manufacturing Co v NZ Security Consultants & Investigations Ltd*,¹⁴⁴ the Court of Appeal declined to hold that an insurer's investigators owed duties of care to insured parties. A proximate relationship existed between the parties because of the vulnerable insured's inability to protect itself from loss, and its close nexus with the investigators' negligence.¹⁴⁵ However, the Court was reluctant to cut across the parties' contractual relationships with the insurer, which already provided sufficient compensation to the insured. The applicability of other torts such as defamation and malicious prosecution also suggested no duty of care should be owed.¹⁴⁶ Arguably, these reasons apply with equal force to insurers, given that the contract of insurance already allocates loss between the parties.¹⁴⁷ However, courts now recognise that concurrent liability in contract and tort frequently arises.¹⁴⁸

Whether insurers owe tortious duties of care is beyond the scope of this dissertation. However, if such a duty were owed, it would differ from a duty of utmost good faith for the same reasons that the CGA cannot fulfil that function:¹⁴⁹ the duties have fundamentally different purposes and focuses. The duty of care concerns the manner of performance and is enforced to protect the insured from loss. A duty of good faith, on the other hand, is concerned with the quality of conduct which could undermine the special relationship of trust and dependence between the parties.

Ltd v Rowles HC Wellington AP131/96, 2 May 1997 and *Keith v AMP Life Ltd* HC Christchurch CP40/98, 20 May 1998.

¹⁴⁴ *South Pacific Manufacturing Co Ltd v New Zealand Security Consultants & Investigations Ltd* [1992] 2 NZLR 282.

¹⁴⁵ At 300 per Cooke P; at 307 per Richardson J; at 318 per Hardie Boys J; and at 325 per Sir Gordon Bisson. Casey J dissented on this point at 314, stating that there was insufficient proximity.

¹⁴⁶ At 303-304 per Cooke P; at 308-309 per Richardson J; at 314 per Casey J; at 319 per Hardie Boys J; and at 326 per Sir Gordon Bisson.

¹⁴⁷ Stephen Todd "Negligence: The Duty of Care" in Stephen Todd (ed) *The Law of Torts in New Zealand* (5th ed, Thomson Reuters, Wellington, 2009) 133 also states at 151 that courts should not recognise duties of care where those duties can only arise through a contractual promise.

¹⁴⁸ *Frost & Sutcliffe v Tuiara* [2004] 1 NZLR 782 at [17] and [22].

¹⁴⁹ See above at III.A.

Exemplary damages could be awarded for breach of a tortious duty of care, if one existed. Such awards could incorporate wide-ranging considerations of an insurer's conduct. However, as no cases have arisen, tort law does not presently perform this function.

VI *Conclusion*

The duty of utmost good faith is a unique obligation because it focuses upon the insurer's conduct and process rather than its performance. So, enforcement of this duty should not focus on compensating for loss. The existing contractual duties already perform that function. However, they fail to recognise the additional wrongs involved in an insurer's bad faith. The FIC may import the unique content of the duty of utmost good faith in claims-handling, but its enforceability is limited.

Therefore, the present law does not adequately protect the interests of vulnerable insured parties. Recent events in Canterbury demonstrate how an insurer may take advantage of its discretion.¹⁵⁰ The duty of utmost good faith could remedy this and could punish or deter bad faith. The next Chapter will consider possible options for reform.

¹⁵⁰ See Chapter 1 at IV.D.

Chapter Three

Options for Reforming the Duty of Utmost Good Faith

I *Introduction*

The enforceability of the insurer's duty of utmost good faith is a live issue, and may soon require resolution given recent events in Canterbury. This Chapter will revise why the duty should be enforced, and what role it should take in insurance disputes. Then, the possible bases of a judicially-enforced duty will be evaluated, before assessing ways of enforcing the duty which would not necessitate litigation.

II *A Possible Role for a Claims-Handling Duty*

There are strong policy reasons in favour of enforcing good faith obligations in claims-handling. The principal reason is the insured's financial and emotional vulnerability. The insurer can take advantage of this as it exercises its considerable discretion in the claims process. Meanwhile, the insured relies upon its insurer to exercise its powers and duties in an appropriate manner. Insurance is designed and marketed to provide peace of mind and security, so the law should protect the insured's expectations, and prevent insurers from taking advantage of their powerful positions.

Compensatory remedies for breaching the existing contractual terms, particularly damages for consequential losses, may deter bad faith to an extent. However, selective and systemic bad faith may still be profitable, so these awards are insufficient.

The existing compensatory remedies should compensate any foreseeable losses flowing from bad faith in claims-handling, although mental distress damages are not available for bad faith *specifically*.¹⁵¹ However, if they were,¹⁵² they would not significantly alter recovery because those damages are already recoverable for breach of the existing contractual duties. If mental distress damages were the principal remedy for bad faith, commercial insureds could go unprotected as companies cannot 'feel' distress and therefore cannot

¹⁵¹ See Chapter 2 at IV.B.

¹⁵² Some academics state that mental distress damages ameliorate the need for any good faith cause of action: John Swan "Punitive Damages for Breach of Contract: A Remedy in Search of a Justification" (2004) 29 Queen's LJ 596 at 614 and, impliedly, Campbell, above n 28 at 212.

recover.¹⁵³ So, making compensatory remedies available for bad faith cannot address the problem as they are unlikely to change the plaintiff's recovery.

The duty of utmost good faith in claims-handling is not a performance obligation. It focuses on the quality of the insurer's conduct, rather than the insured's loss. This suggests that the duty should be used to mark society's disapproval of an insurer's conduct and to deter future breaches, rather than focusing on compensation. Punishing such breaches could achieve this effect.

The idea of enforcing a civil duty in order to deter conduct through punishment is at odds with how private law is generally understood. Civil law is principally designed to compensate the victim for the loss flowing from a wrong.¹⁵⁴ In *Couch v Attorney-General*, Blanchard J stated "there is a real question whether a civil court should involve itself in punishing people".¹⁵⁵ So, aside from exceptional cases in tort,¹⁵⁶ punishment is largely seen to be the function of the criminal law.¹⁵⁷

However, punishment can be a legitimate objective in civil law because it serves a socially usefully need to deter undesirable conduct.¹⁵⁸ Without deterrence, an individual's rights and interests would be incompletely protected, and there would be a moral gap in the law.¹⁵⁹ Punishment is particularly appropriate in claims-handling because it can restrain abuses of power by those specially placed to interfere with others and who are able to disregard the financial consequences.¹⁶⁰ The law should therefore be able to support objectives which protect the vulnerable insured. Not every instance of bad faith need be punished; examples can be set by only punishing breaches of sufficient gravity.

The basis of the duty of utmost good faith has not been determined. Therefore, in asking whether the law can enforce a duty for the purpose of deterrence, it is necessary to consider how the duty is best conceptualised within the law.

¹⁵³ *Mouat v Clark Boyce* (No 2) [1992] 2 NZLR 559 at 569 per Cooke P on the basis that commercial contracts cannot be designed to avoid anxiety. Note that this case was not in the insurance context.

¹⁵⁴ Stephen Todd "General Introduction" in Stephen Todd (ed) *The law of torts in New Zealand* (5th ed, Thomson Reuters, Wellington, 2009) 1 at 4-5.

¹⁵⁵ *Couch v Attorney-General*, above n 141 at [59].

¹⁵⁶ Todd, above n 154 at 4, with regard to awards of exemplary damages.

¹⁵⁷ Stephen Todd "Remedies for breach of contract" in John Burrows, Jeremy Finn and Stephen Todd (eds) *Law of Contract in New Zealand* (4th ed, LexisNexis NZ, Wellington, 2012) 819 at 845.

¹⁵⁸ *Whiten v Pilot Insurance Co* [2002] 1 SCR 595 at [36]-[37].

¹⁵⁹ James Edelman "In Defence of Exemplary Damages" in Charles EF Rickett (ed) *Justifying Private Law Remedies* (Hart Publishing, Oxford, 2006) 225 at 227.

¹⁶⁰ Stephen Todd "Exemplary Damages" (1998) 18 NZULR 145 at 148.

III *Option 1: Implying a Contractual Duty of Utmost Good Faith*

In *Pegasus Group Ltd v QBE Insurance (International) Ltd*, Winkelmann J indicated that the duty of utmost good faith could be contractually enforced.¹⁶¹ Further, in *Barron v Hutton*, Toogood J struck out a good faith cause of action by a third party against a liability insurer on the ground that the duty arose by virtue of the insurance contract.¹⁶² This indicates that contract law is the best starting point for enforcing the duty.

A *The Ability to Imply the Duty*

Campbell states that a duty of utmost good faith in claims-handling could be judicially implied into insurance contracts in two ways.¹⁶³ First, the term could be implied where it is reasonable, clear, obvious and necessary for business efficacy.¹⁶⁴ The court respects the consensual nature of the contract,¹⁶⁵ as it essentially infers an intention to incorporate that term.¹⁶⁶ However, this line of authority implies contractual terms in *fact*, rather than in law. A duty of utmost good faith is justified by inherent aspects of the insurance relationship: the insurer's considerable discretion, and the insured's corresponding vulnerability. Because of this, if the duty of utmost good faith is to be implied, it should be implied in law, not on a case-by-case basis.

The term could therefore be implied as a matter of presumption in all insurance contracts, unless the parties express themselves otherwise.¹⁶⁷ A concern is that insurers could expressly exclude the duty, and it would be contradictory for a contract to be able to exclude a fundamental principle underlying it.¹⁶⁸ If a statutory duty implied the term it could, as in Australia, elevate it to paramount status so it “is not limited or restricted in any way by any other law”.¹⁶⁹

¹⁶¹ *Pegasus Group Ltd v QBE Insurance (International) Ltd*, above n 24 at [279].

¹⁶² *Barron v Hutton*, above n 2 at [47].

¹⁶³ Campbell, above n 28 at 215.

¹⁶⁴ *BP Refinery (Westernport) Pty Ltd v Shire of Hastings* (1977) 16 ALR 363 at 376

¹⁶⁵ Campbell, above n 28 at 215.

¹⁶⁶ Edwin Peel *The Law of Contract* (13th ed, Sweet & Maxwell, London, 2011) at 230.

¹⁶⁷ Campbell, above n 28 at 215.

¹⁶⁸ Law Commission for England and Wales and Scottish Commission, above n 90 at [4.51].

¹⁶⁹ Insurance Contracts Act 1984 (Cth), s 12.

The relevant test is whether it is *necessary* to imply the particular term,¹⁷⁰ taking into account wider considerations of the *type* of relationship.¹⁷¹ It has been stated that it is better to consider relevant policy and the reasonableness and fairness of the term, rather than focusing on the “elusive” concept of necessity.¹⁷² However, that decision has been held not to have rejected the necessity element.¹⁷³

In my opinion, to adequately perform an insurance contract, the insurer must act in good faith during the claims process. Bad faith is likely to obstruct the fundamental purposes of insurance contracts: indemnification for loss and providing peace of mind. However, the pertinent question is whether it is necessary to *imply* this obligation into the existing contractual framework. As Campbell points out, “given that insurance contracts appear to have worked fairly well for centuries without the parties ever having expressly included a good faith obligation, it is difficult to see that [an argument of necessity] could successfully be developed”.¹⁷⁴

The Australian law casts doubt on the necessity for implying a contractual term of good faith. It would also be relevant to considering whether the New Zealand legislature should follow its Australian counterpart and statutorily classify the duty as contractual.

B *The Australian Approach as a Model for Reform*

Section 13 of the Insurance Contracts Act 1984 (“ICA”) provides:

A contract of insurance is a contract based on the utmost good faith and there is implied in such a contract a provision requiring each party to it to act towards the other party, in respect of any matter arising under or in relation to it, with the utmost good faith.

Before this Act, the only remedy for bad faith was avoidance of an insurance policy. Because of this, there were no reported cases in which the duty of utmost good faith operated to the benefit of the insured.¹⁷⁵ Kirby J has described this state as a “one-way street”, favouring only insurers’ interests.¹⁷⁶

¹⁷⁰ *Liverpool City Council v Irwin* [1977] AC 239 at 256 per Lord Wilberforce; 258 per Lord Cross of Chelsea; per Lord Salmon at 262-263; per Lord Edmund-Davies at 265-266; and Lord Fraser concurring at 270.

¹⁷¹ *Sally v Southern Health & Social Services Board* [1992] 1 AC 294 at 307.

¹⁷² *Crossley v Faithful & Gould Holdings Ltd* [2004] EWCA Civ 293 at [36].

¹⁷³ *Makers UK Ltd v Camden LBC* [2008] EWHC 1836 (TCC) at [27].

¹⁷⁴ Campbell, above n 28 at 215.

¹⁷⁵ *CGU Insurance Ltd v AMP Financial Planning Pty Ltd*, above n 21 at [126].

¹⁷⁶ At [127].

When the ICA came into force, it adopted a recommendation to allow damages for breach of the insurer's duty, "based on ordinary contractual principles".¹⁷⁷ However, it is questionable whether s 13 has really advanced insurance law beyond the common law position.¹⁷⁸ Australian courts and counsel rarely utilise s 13 in insurance litigation,¹⁷⁹ and only three cases discuss it in the claims-handling context.¹⁸⁰

The rare invocation of this duty in litigation is probably due to its remedy of ordinary contractual damages. Allowing damages for breach gives the duty more force; but that force is largely symbolic. Losses suffered as a result of bad faith should already be recoverable by proving a breach of the express contractual terms.

Further, s 13 does not relax the prerequisites for liability. In *CGU Insurance Ltd v AMP Financial Planning Ltd*, it was emphasised that a finding of breach cannot operate as a punitive sanction for bad faith. Principled reasoning must connect the breach and liability.¹⁸¹ So, it is necessary to examine what *follows* from bad faith before recovering for loss;¹⁸² damages are no more readily available under s 13 than under the contract.

Because of this, the insured need not rely on s 13 to obtain a remedy, and doing so could be inefficient. The insured would have to show a wrongful delay or non-payment which caused foreseeable loss, just as in an ordinary contractual case. However, under s 13, the insured would have to prove the additional element of bad faith.

As a result, the contractual duty of utmost good faith has not made a practical difference in Australian insurance litigation. By analogy, it would be very difficult to establish that it is necessary to imply the duty in New Zealand, or that the duty in its contractual form could have any meaningful implications at all.

C *Wider Considerations*

A court, and of course the legislature, may assess considerations other than necessity.¹⁸³ Implying a duty of utmost good faith into insurance contracts would have a symbolic effect, showing the important place of good faith in insurance law. It may give judges a

¹⁷⁷ Australian Law Reform Commission *Insurance Contracts* (ALRC 20, 1982) at [328].

¹⁷⁸ Ron Ashton "Keeping the faith - Good faith in insurance and the emergence of general contractual good faith" (2011) 22 ILJ 10 at 88 and 90.

¹⁷⁹ O'Neill, above n 96 at 254 and Ashton, above n 178, at 88.

¹⁸⁰ See the discussion *Moss v Sun Alliance Australia Ltd*, above n 66, *Gutteridge v Commonwealth*, above n 69 and *CGU Insurance Ltd v AMP Financial Planning Pty Ltd*, above n 21, in Chapter 1.

¹⁸¹ *CGU Insurance Ltd v AMP Financial Planning Pty Ltd*, above n 21, at [16].

¹⁸² Ashton, above n 178, at 89.

¹⁸³ See above at III.A.

mandate to express disapproval of unfairness, and assist insureds in the opening stages of disputes. Fear of judicial and public censure may deter insurers from bad faith.¹⁸⁴

However, the FIC already effectively recognises a duty of good faith in claims-handling.¹⁸⁵ So, even though the FIC is 'soft' law, insurers are cognisant of the expectations placed upon them. The symbolic effect of a duty is not missing; the problem is its enforcement.

The availability of exemplary damages in contract in New Zealand has been decisively rejected.¹⁸⁶ In contrast, a Canadian case, *Whiten v Pilot Insurance*, has allowed recovery of exemplary and aggravated damages for breach of an implied contractual duty of good faith. The basis of such awards is that the duty is independent of and additional to the policy's express obligations.¹⁸⁷

New Zealand courts would be unlikely to follow *Whiten* as an inroad on *Paper Reclaim*. First, *Whiten* has been criticised for not considering the need for punitive damages in contract.¹⁸⁸ Exemplary damages distort the function of contract law, which is to put the plaintiff in as good a position as if the contract had been performed.¹⁸⁹ Further, *Whiten* does not explain how the idea of an additional wrong overcomes the undesirability of state intervention in private relationships.¹⁹⁰ Finally, *Paper Reclaim* apparently rejected this line of authority,¹⁹¹ and declined to leave the availability of exemplary damages open for exceptional cases.¹⁹² Courts would be reluctant to depart from that definitive judgment and its consequential certainty for litigation.

Therefore, a contractual duty of good faith could not produce any additional remedies for the insured, and so it cannot meaningfully deal with bad faith. This is because contract law is not an appropriate avenue to address this issue. Contract law compensates for loss, and punishment is inconsistent with this aim. In contrast, the duty of good faith is concerned with denouncing conduct which undermines a special relationship of vulnerability and dependence, whether or not loss is caused. These separate aims do not sit together

¹⁸⁴ Ashton, above n 178, concedes at 90 that Australia's s 13 may have had a deterrent effect on insurers.

¹⁸⁵ See Chapter 2 at II.

¹⁸⁶ See the discussion of *Paper Reclaim Ltd v Aotearoa International Ltd*, above n 142 in Chapter 2 at IV.B.

¹⁸⁷ *Whiten v Pilot Insurance Co*, above n 158 at [79] per Binnie J, with McLachlin CJC, L'Heureux-Bube, Gunthier, Major and Arbour JJ concurring, and LeBel J concurring on this point in a separate judgment at [143].

¹⁸⁸ John McCamus "Prometheus Bound or Loose Cannon? Punitive Damages for Pure Breach of Contract in Canada" (2004) 41 San Diego L Rev 1491 at 1510.

¹⁸⁹ Swan, above n 152 at 646.

¹⁹⁰ McCamus, above n 188 at 1504.

¹⁹¹ See *Paper Reclaim Ltd v Aotearoa International Ltd*, above n 186 at [177]-[179].

¹⁹² At [181].

comfortably. Thus, a contractual duty would not be a satisfactory way to enforce good faith obligations.

IV *Option 2: Recognising a Tortious Duty of Utmost Good Faith*

A *The Approach in Recognising a New Tort*

The first question to be asked is what interest is to be protected.¹⁹³ In this context, that would be the insured's interest in having its claim handled in a fair and reasonable manner. In deciding whether tort law should protect this interest, the courts must examine the fairness and justice of the situation.¹⁹⁴ In *Hosking v Runting*, Gault P stated:¹⁹⁵

The courts are at pains to ensure that any decision extending the law to address a particular case is consistent with general legal principle and with public policy and represents a step that is appropriate for the courts to take.

Relevant considerations include legal certainty and coherence; the practicability of circumscribing a defined cause of action; commercial convenience; the promotion of autonomy and self-reliance; and the deterrent and economic effects of the decision.¹⁹⁶

B *Evaluation*

I have outlined the policy reasons which justify enforcing a duty of utmost good faith on insurers in claims-handling.¹⁹⁷ This section asks whether a tortious obligation is the appropriate way to do this.

1 *The relationship between tort and contract*

It is arguable that insurance contracts provide adequate remedies for the harms of bad faith, so a tortious duty of good faith is not required to provide further relief.¹⁹⁸ However, the contractual duty to indemnify does not recognise additional wrongs committed by the insurer (particularly unfairness rather than delay), and therefore does not adequately address bad faith. Further, in general principle, there is no objection to remedies

¹⁹³ Todd, above n 154 at 8.

¹⁹⁴ At 12-13.

¹⁹⁵ *Hosking v Runting* [2005] 1 NZLR 1 at [5].

¹⁹⁶ Todd, above n 154 at 13.

¹⁹⁷ See II.

¹⁹⁸ The comprehensive contractual remedies precluded a duty of care being owed by insured parties by investigators in *South Pacific Manufacturing Co Ltd v New Zealand Security Consultants & Investigations Ltd*, above n, 144 discussed in Chapter 2 at V.

overlapping between contractual and tortious causes of action.¹⁹⁹ The Court of Appeal has accepted that contractual and tortious causes of action are frequently co-extensive.²⁰⁰

On the other hand, it has been argued that recognising a tort of good faith would be inconsistent with freedom of contract: the idea that the parties have voluntarily come to an agreement, so courts should be reluctant to intervene.²⁰¹ As Richardson J pointed out in *South Pacific*, courts should not give greater recovery in tort than the insured was willing to pay for in contract;²⁰² and insurance contracts already allocate loss between the parties. More recently, the Court of Appeal has stated that tort should generally refrain from imposing a wider duty than that under the contract. However, a wider duty may be acceptable if justified by significant policy reasons, or if facts irrelevant in contract law are of consequence in tort.²⁰³ The ‘additional wrong’ of bad faith committed by an insurer may be inconsequential in contract but because bad faith is fault-based, there are strong policy reasons for addressing it in tort. So, whilst the existing contractual remedies suggest caution should be exercised, a bad faith tort may not be entirely precluded.

2 *The objectives of tort law*

A significant objective of tort law is to allocate loss between two parties.²⁰⁴ I have argued above that the duty of utmost good faith is concerned with regulating conduct, not compensating for loss. The duty did not sit comfortably in contract law because that framework is concerned with performance and loss.²⁰⁵ However, tort law is not a purely compensatory model.²⁰⁶ It is capable of embracing another objective, even if it is a subsidiary one: punishing and thereby deterring blameworthy behaviour. As tortious obligations are imposed rather than assented to, and liability is fault-based, punishment appears to be more appropriate in tort than under contract law.²⁰⁷

In *CGU Workers Compensation (NSW) Ltd v Garcia*,²⁰⁸ the New South Wales Court of Appeal declined to impose a tortious obligation of good faith in workers’ compensation

¹⁹⁹ Todd, above n 154 at 6.

²⁰⁰ *Frost & Sutcliffe v Tuiaara*, above n 148 at [17] and [22].

²⁰¹ Craig Brown "Damages for bad faith denial of insurance claims in Canada: Continuing a tradition of judicial restraint" (2002) NZ L Rev 453 at 463.

²⁰² *South Pacific Manufacturing Co Ltd v New Zealand Security Consultants & Investigations Ltd*, above n 144 at 308.

²⁰³ *Frost & Sutcliffe v Tuiaara*, above n 148 at [22].

²⁰⁴ Todd, above n 154 at 8.

²⁰⁵ See III.C.

²⁰⁶ Todd, above n 160 at 147.

²⁰⁷ At 165-166.

²⁰⁸ *CGU Workers Compensation (NSW) Ltd v Garcia*, above n 25.

insurance.²⁰⁹ Mason P stated “I do not feel justified in entering the field of exemplary damages by the back door” given their unavailability in contract.²¹⁰ This position is only defensible to the extent that the reasons not to award exemplary damages in contract apply to the obligation of good faith.

A significant reason for not awarding exemplary damages in contract is that contract law does not impose an absolute duty on the parties to meet their promises. Instead of compelling performance, a party may compensate the other party for their loss.²¹¹ This allows parties to pursue wealth-enhancing options which maximise their efficiency.²¹² However, efficient breach of good faith obligations should not be condoned, because it would undermine the special insurance relationship. A higher standard of conduct is expected to protect the vulnerable insured. This suggests good faith should not be understood in the same way as an ordinary contractual duty, and therefore the “back door” objection is less persuasive.

Another criticism of exemplary damages is that they introduce indeterminacy and uncertainty.²¹³ The Canadian awards of aggravated and exemplary damages shed further light on this issue. Aggravated damages compensate the plaintiff for humiliation, anxiety and other mental effects of high-handed conduct.²¹⁴ Punitive damages aim to achieve retribution, deterrence and denunciation of high-handed, harsh, malicious, or highly reprehensible conduct. The award must be reasonably proportionate to the relevant harm, the degree of misconduct, the plaintiff’s vulnerability and any advantages gained by the defendant, in light of compensatory awards.²¹⁵

Awards of punitive damages have tended to be reasonably small: generally within the range of \$7,500 to \$15,000 at the time of *Whiten*.²¹⁶ However, there have been some significant awards. In *Whiten*, the jury at first instance awarded \$1,000,000 in punitive damages. The Ontario Court of Appeal reduced this award as it was an excessive departure from

²⁰⁹ Workers’ compensation insurance is excluded from the operation of the ICA: s 9(1)(e)(i), ICA.

²¹⁰ *CGU Workers Compensation (NSW) Ltd v Garcia*, above n 21 at [73].

²¹¹ Todd, above n 160 at 164-165.

²¹² This was a significant reason given in *Paper Reclaim Ltd v Aotearoa International Ltd*, above n 142 at [172]. See also Todd, above n 160 at 165.

²¹³ Law Commission for England and Wales and Scottish Law Commission, above n 90 at [4.47] and Law Commission for England and Wales and Scottish Law Commission *Consultation Paper: Post contract duties and other issues* (2011) at [4.38]-[4.40].

²¹⁴ *Hill v Church of Scientology of Toronto* [1995] 2 SCR 1130 at [188]-[189].

²¹⁵ *Whiten v Pilot Insurance Co*, above n 158, at [94].

²¹⁶ *Whiten v Pilot Insurance Co* [1999] 42 OR (3d) 641 at [39] and [51] (CA).

precedent,²¹⁷ but the Supreme Court of Canada reinstated it. Binnie J stated that although he would not have awarded that amount, it was not irrationally disproportionate and “did not overshoot its purpose”.²¹⁸ In *Clarfield v Crown Life Insurance Co*, a judge awarded an insured \$75,000 in aggravated damages and \$200,000 in punitive damages for unbalanced and unreasonable claims-handling practices.²¹⁹ In another case, \$100,000 in punitive damages was awarded after an insurer overlooked vital evidence.²²⁰

Significant awards may effectively deter bad faith as they cannot be absorbed as a cost of doing business. They can negate the profit incentive to sustain unfair practices. However, even if awards are generally modest, isolated instances of large awards introduce unpredictability into the law and encourage litigation. Despite Binnie J’s judgment, these awards have arguably exceeded their purposes of deterrence, retribution and denunciation, even if the insurer’s considerable resources are considered.²²¹ They therefore demonstrate the difficulty in impartially quantifying an appropriate level of punishment for an insurer’s actions. So, whilst New Zealand courts strive for a tradition of modesty in tortious cases,²²² these cases show that caution is needed, particularly in commercial relationships where certainty is paramount.

Another concern is that allowing exemplary damages for bad faith could raise the costs of insurance generally. However, awarding damages for bad faith has had minimal effects on Canadian pricing of insurance. This is because of the rarity of bad faith cases, the existence of price competition and a general judicial respect for the sanctity of contracts.²²³

3 *The utility of a tortious duty*

Another limitation is that individual insureds must pursue litigation in order for a tortious duty to have a deterrent effect. Litigation is costly and time-consuming, which makes it an undesirable option for an insured that is economically vulnerable after a non-payment or delayed payment of a claim. Further, addressing bad faith in isolated cases may not deter bad faith on a systemic level, particularly given the profit-making incentives to act in bad faith.

²¹⁷ At [50]-[51] and [66] per Finlayson JA, Catzman JA concurring.

²¹⁸ *Whiten v Pilot Insurance Co*, above n 158, at [128] per Binnie J.

²¹⁹ *Clarfield v Crown Life Insurance Co* [2000] 50 OR (3d) 696.

²²⁰ *Kogan v Chubb Insurance Co of Canada*, above n 81.

²²¹ Note that in *Whiten v Pilot Insurance Co*, above n 158 at [118]-[119], it was stated that a defendant’s financial power is of limited importance in calculating an award.

²²² See *McDermott v Wallace* [2005] 3 NZLR 661 at [94]-[98].

²²³ *Brown*, above n 201 at 465.

Even when explicated as a duty of fairness and reasonableness, the duty is inherently vague and context-specific. Law Commissions in the United Kingdom have considered this uncertainty so problematic that it would preclude the creation of an implied contractual term of good faith.²²⁴ Similar concerns would apply in tort law. Bad faith may be obvious with the benefit of hindsight; but it would be difficult for insurers to plan in advance, and this may cause them to be unduly cautious in denying liability, thereby making the industry less efficient. Further, a broad duty could encourage litigation, as insureds “with stars in [their] eyes”²²⁵ attempt to use the duty to their advantage.

In any event, difficulties in proof could prevent the recovery of exemplary damages. It would be difficult to establish the requisite unreasonableness or unfairness because to find bad faith, a court must exclude any reasonable justifications for an insurer’s conduct. Inferring subjective recklessness or intention on the part of a corporation would also be problematic. The insured must also show that the unreasonable conduct was outrageous, arbitrary or high-handed to the point of deserving punishment over and above compensatory damages.²²⁶ Few cases could satisfy all of these requirements. This was demonstrated in *Cedenco Foods*, where a lengthy, unexplained delay was insufficient to be outrageous.²²⁷ The insurer’s slow response and unsatisfactory assessment process in *Pegasus* also failed to reach that threshold.²²⁸ So, exemplary damages would rarely be available and may not be able to sufficiently counteract the financial incentive to act in bad faith.

As torts do not tend to be actionable *per se* only where only economic interests are concerned,²²⁹ this tort would probably require proof of actual loss being caused before awarding exemplary damages. This again produces a loss-based approach and would mean that such awards would depend on claim validity.

This analysis suggests the duty of good faith should not be enforced through tort. Although exemplary damages would deter bad faith by focusing on an insurer’s conduct, the associated uncertainty in enforcing a duty of good faith arguably outweighs that value. Further, the effectiveness of a tortious duty is questionable given the difficulty in proving

²²⁴ Law Commission for England and Wales and Scottish Law Commission, above n 90 at [4.50].

²²⁵ *Paper Reclaim Ltd v Aotearoa International Ltd*, above n 142 at [181] when discussing whether the court should leave open, in contract cases, the possibility of exemplary damages for exceptional cases.

²²⁶ *Couch v Attorney-General*, above n 141 at [65] per Blanchard J and [145] per Tipping J.

²²⁷ *State Insurance Ltd v Cedenco Foods Ltd*, above n 87 (CA).

²²⁸ *Pegasus Group Ltd v QBE Insurance (International) Ltd*, above n 24 at [279].

²²⁹ The position is different where bodily integrity or property rights are concerned. See for example John Smillie "Trespassing on Land" in Stephen Todd (ed) *The Law of Torts in New Zealand* (5th ed, Thomson Reuters, Wellington, 2009) 423 at 9.2.03 and Stephen Todd "Trespass to the Person" in Stephen Todd (ed) *Law of Torts in New Zealand* (5th ed, Thomson Reuters, Wellington, 2009) 93 at 4.2.

sufficient bad faith. Therefore, although the duty fits more comfortably in the tort law framework than the contractual one, courts should refrain from creating a tortious duty.

V Option 3: Recognising an Equitable Duty of Utmost Good Faith

In *Cedenco Foods*, Thomas J stated that the duty of utmost good faith was equitable.²³⁰ Subsequent cases have been less certain of this; in *Pegasus*, Winkelmann J left open whether the basis of the duty was equitable or contractual.²³¹

Thomas J cited no authority for the 'equitable' duty, but probably drew on the English decision of *Banque Keyser Ullmann SA v Skandia (UK) Insurance Co Ltd*.²³² In that case, Slade LJ held that pre-contractual disclosure obligations of good faith were equitable. This followed from the equitable origin of powers to grant relief for innocent misrepresentations in contracts *uberrimae fidei*.²³³ This has been criticised as the duty of disclosure in insurance originated in a common law case:²³⁴ *Carter v Boehm*.²³⁵ The reasoning in *Skandia* does not translate to the claims-handling context, which would not usually involve issues of disclosure. Because the duty of good faith creates specific duties rather than comprising one free-standing obligation,²³⁶ a claims-handling duty need not have the same juristic basis as a pre-formation disclosure duty. These specific duties have differing content, are imposed on different parties, and arise at different times. The bases of these duties should also be allowed to vary, to ensure appropriate outcomes.²³⁷ Further, *Skandia* should not be followed as the only remedy for bad faith would be avoidance. In *Barron*, Toogood J stated he was not certain that *Skandia* reflected New Zealand law in this respect.²³⁸ Avoiding the contract would be thoroughly unsatisfactory in claims-handling as the insured would lose its right to its valid claim.

²³⁰ *State Insurance Ltd v Cedenco Foods Ltd*, above n 87 (CA).

²³¹ *Pegasus Group Ltd v QBE Insurance (International) Ltd*, above n 24, at [279].

²³² *Banque Keyser Ullmann SA v Skandia (UK) Insurance Co Ltd*, above n 39.

²³³ At 780.

²³⁴ John Birds *Birds' Modern Insurance Law* (8th ed, Sweet & Maxwell, London, 2010) at 158 and Richard Aikens "The post-contract duty of good faith in insurance contracts: Is there a problem that needs a solution?" (2010) 5 JBL 379 at 391.

²³⁵ *Carter v Boehm*, above n 1.

²³⁶ See Chapter One at ILC.

²³⁷ Slade LJ seemed to acknowledge this when he stated that post-formation duties of good faith could be implied contractual terms in particular factual situations: *Banque Keyser Ullmann SA v Skandia (UK) Insurance Co Ltd*, above n 39 at 777.

²³⁸ *Barron v Hutton*, above n 2 at [45].

A justification for an equitable duty of utmost good faith is its similarity with the idea of unconscionability which underlies many equitable causes of action.²³⁹ Both are flexible ideas requiring fair dealing by a stronger party, and are breached by unfair or unreasonable conduct.²⁴⁰ As a conduct obligation, the duty of utmost good faith is more like an equitable obligation than a common law right designed to allocate loss. This means the duty could sit more comfortably in equity.

Damages are recoverable in equity,²⁴¹ including exemplary damages.²⁴² In *Cedenco*, Thomas J contended that compound interest could be available for bad faith,²⁴³ which could deter bad faith without over-compensating the insured.²⁴⁴ However, equity could only step in where the common law could not accommodate an obligation of good faith, as equity is designed to supplement the law.²⁴⁵ An equitable duty would suffer from the same flaws as a tortious one: the duty is uncertain; bad faith is difficult to prove; and individual insureds may be unwilling to litigate in order to enforce the duty. Because of this, the judicial system is not the best way to protect the insured's interest in having its claim handled in good faith. The rest of this Chapter will consider non-judicial options.

VI *Option 4: A Statutory Duty, Enforced by an Administrative Body*

Statutory reform could allow an administrative body to enforce the duty of utmost good faith. The Insurance Contracts Amendment Bill 2010 ("ICAB") was drafted in Australia, apparently under the assumption that the low number of claims under the ICA was because insureds did not pursue breaches, not because insurers acted honestly.²⁴⁶ The Bill passed through the House of Representatives, but lapsed in the Senate. However, it still represents a possible option for addressing insurer bad faith in New Zealand.

²³⁹ See Andrew Butler "Introduction to Modern Equity" in Andrew Butler (ed) *Equity and Trusts in New Zealand* (2nd ed, Thomson Reuters, Wellington, 2009) 467.

²⁴⁰ Stanley Drummond "Unconscionable conduct and utmost good faith" (2003) 4(2) ILJ 208 at 209.

²⁴¹ The Chancery Amendment Act 1858 (also known as Lord Cairns' Act) first allowed certain courts to award damages in equity. See also *Day v Mead* [1987] 2 NZLR 443.

²⁴² *Aquaculture Corp v NZ Green Mussel Co Ltd* [1990] 3 NZLR 299 at 301-302 per Cooke P, Richardson, Bisson and Hardie Boys JJ. Somers J dissented on this point at 302, stating that equity and penalty are strangers.

²⁴³ *State Insurance Ltd v Cedenco Foods Ltd*, above n 87 (CA).

²⁴⁴ Neil Campbell "Review: Insurance Law" (1999) NZ L Rev 191 at 204.

²⁴⁵ *Telecom New Zealand Ltd v Sintel-Com Ltd* [2008] 1 NZLR 780 at [46] per Hammond J.

²⁴⁶ O'Neill, above n 96 at 255.

A *The Insurance Contracts Amendment Bill 2010*

The ICAB would have made a breach of s 13 constitute a breach of the ICA, and would enable the Australian Securities and Investments Commission (“ASIC”) to enforce the duty.²⁴⁷ If an insurer breached s 13 in handling or settling a claim (or potential claim), ASIC could exercise the following powers under the Corporations Act 2001:²⁴⁸

- (i) Suspending or cancelling an Australian financial services licence either immediately or following a hearing,²⁴⁹ and
- (ii) Making a permanent or temporary banning order which prohibits a person from providing any financial services, or specified financial services in specified circumstances or capacities.²⁵⁰ Conduct which breaches a banning order also contravenes the Corporations Act.²⁵¹

Michael Kirby approved the report which led to ICAB, stating that active enforcement and administration would be beneficial, rather than expecting the ICA to be self-administering. However, a proper balance would need to be struck between protection and industry efficiency.²⁵² Others expressed similar concerns about the risk of frequent intervention, insufficient guidance for ASIC in exercising its powers and administration costs.²⁵³

B *A Possible Form for this Option*

Essentially, an administrative body, such as the Commerce Commission,²⁵⁴ could investigate and impose sanctions for bad faith in claims-handling, including censure, monetary penalties and the suspension or cancellation of an insurer’s licensing or QFE status.²⁵⁵ The latter sanctions would hinder the insurer’s ability to contract with prospective insureds. Monetary penalties were deliberately excluded in ICAB, although the preceding

²⁴⁷ Insurance Contracts Amendment Bill 2010 (Cth), cl 4.

²⁴⁸ Clause 5.

²⁴⁹ Corporations Act 2001 (Cth), Part 7.6, Division 4, Subdivision C, ss 915B and 915C.

²⁵⁰ Part 7.6, Division 8, Subdivision A, ss 920A and 920B.

²⁵¹ Section 920C.

²⁵² Michael Kirby "Australian insurance contract law: Out of the chaos - A modern, just and proportionate reforming statute" (2011) 22 ILJ 1 at 57.

²⁵³ See O'Neill, above n 96 at 259-261.

²⁵⁴ The Commerce Commission was cited here because of its present role in administering the Fair Trading Act 1986. However, the Financial Markets Authority or a new body could also fill this role.

²⁵⁵ I have included draft statutory provisions for giving effect to this in Appendix 1 (with the latter sanction affecting the insurer’s QFE status rather than its licence under the Insurance (Prudential Supervision) Act 2010 or registration under the FSPA.

report did not explain why.²⁵⁶ However, if Parliament legislated to deter bad faith, a monetary penalty is a good option. It counteracts the financial incentive to act in bad faith. Along with censure, it would fill the gap left by situations where conduct is sufficiently blameworthy to warrant punishment, but is not so outrageous as to warrant interference with the insurer's commercial activities. Otherwise, the possible sanctions may be so heavy-handed that they would remain unused.

This would not be a dispute resolution scheme. That role can be fulfilled through an insurer's internal complaint mechanisms, the ISO scheme and the judicial system.²⁵⁷ Administrative body intervention would be designed to address the particular problem of bad faith. It need not award damages to the insured to accomplish this.

3 *Evaluation*

There are certain advantages to administrative intervention: large resources; coverage over the entire industry; effective compulsion and enforcement mechanisms; and impartiality.²⁵⁸ Further, the ability to publicly notify sanctions imposed on insurers could severely affect an insurer's reputation and ability to compete.

This proposal could also address systemic bad faith in a way which litigating individual breaches of good faith could not. It would not require insureds to police good faith themselves, so insureds may settle with an insurer without the breach going unnoticed, or incurring the expense of litigation. It would also draw attention to cases of bad faith where a claim was not covered by an insurance policy.

However, government intervention must be necessitated by a market failure which creates a significant risk of harm to the public.²⁵⁹ In this context, the market failure would be the risk of bad faith producing socially undesirable results.²⁶⁰ The nature of this risk, existing means of protection and the ability of the industry to regulate itself must be considered.²⁶¹ Here, contracts of insurance adequately compensate the insured for the harms caused by

²⁵⁶ Alan Cameron and Nancy Milne, *Review of the Insurance Contracts Act 1984: Final Report on second stage: Provisions other than s 54*, June 2004 at 1.8.

²⁵⁷ For the ISO's ability to award compensatory remedies like damages for mental distress and consequential losses, see Insurance and Savings Ombudsman Scheme "Terms of Reference", above n 102, cl 14.3.

²⁵⁸ New Zealand Ministry of Consumer Affairs (April 1997) "Market Self-Regulation and Codes of Practice" (April 1997) <www.consumeraffairs.govt.nz> at 4.1 and Press Council "Review of the New Zealand Press Council" (November 2007) <www.presscouncil.org.nz> at III.3.

²⁵⁹ Cabinet Office Circular "Policy Framework for Occupational Regulation" (8 June 1999) CO 99/6 at [6] and New Zealand Ministry of Consumer Affairs *Review of Industry-Led Regulation - Discussion Paper* (July 2005).

²⁶⁰ BusinessNZ *Regulation Perspectives* (12 July 2006) at 4.

²⁶¹ Cabinet Office Circular, above n 259, Chart 1.

bad faith. Further, the FIC already regulates the industry. This suggests that convincing evidence of widespread bad faith would be required to justify an additional layer of heavy-handed state regulation.

The creation of licensing, registration or authorisation sanctions would require significant modification of current statutory schemes. Two regulatory statutes are particularly relevant. First, the IPISA licenses persons that carry on insurance business in New Zealand.²⁶² None of the grounds for the cancellation of licenses concern an insurer's conduct in relation to consumers.²⁶³ Rather, the scheme of the Act focuses on the relationship between insurers and the Reserve Bank of New Zealand. Adding a 'bad faith' ground to suspend or cancel a license would therefore be a radical policy change for this statute.

The FAA regulates the provision of financial adviser services, including making recommendations in relation to the acquiring or disposing of insurance.²⁶⁴ Actions during claims-handling would not affect registration or authorisation to provide financial adviser services.²⁶⁵ The FAA could be modified to make the suspension or cancellation of an insurer's QFE status a sanction for bad faith in claims-handling, which would prevent QFE advisers from advising others in relation to acquiring insurance.²⁶⁶

Under the FAA, advisers and QFEs must not engage in conduct which is likely to mislead and deceive,²⁶⁷ and AFAs are subject to a Code which sets out minimum standards of ethical behaviour and client care.²⁶⁸ Breach of Code standards opens AFAs to disciplinary action including censure, fines and the cancellation or suspension of authorisation.²⁶⁹ So, the customer protection focus of the FAA is more consistent with the aim of protecting insureds. However, it would be a substantial change to impose sanctions affecting an insurer's QFE status for bad faith in providing services outside the scope of the FAA.

²⁶² Insurance (Prudential Supervision) Act 2010, s 5. A person carries on insurance business if it accepts risks on behalf of others through contracts of insurance, and is liable under such a contract in New Zealand (s 8). Therefore, if bad faith became a ground for suspension or cancellation of a licence, the legislature would need to be clear that this sanction would only affect the insurer's ability to accept risks, and not its liability under contracts of insurance.

²⁶³ See s 30.

²⁶⁴ Financial Advisers Act 2008, ss 9-10.

²⁶⁵ See the discussion of this legislation in Chapter 2 at II.

²⁶⁶ The sanction would affect QFE advisers because under s 5, a QFE adviser is an individual who is an employee of a QFE. The provisions would need to be clear that this sanction would not affect advice in relation to the disposing of insurance, as this could adversely affect the insured's interests if the insurer's bad faith prompted it to change its insurer. It would also need to inhibit AFA employees of the insurer from advising in relation to the acquiring of insurance.

²⁶⁷ Sections 34 and 47. This conduct is an offence under ss 118 and 130.

²⁶⁸ Schedule to the Financial Advisers (Code of Professional Conduct for Authorised Financial Advisers) Notice 2010. See especially Code Standards 1, 2 and 6.

²⁶⁹ Financial Advisers Act 2008, s 101.

The policy development and regulatory changes required for either statute would be costly for taxpayers.²⁷⁰ Maintaining this system would also be costly,²⁷¹ and whilst insurers could be levied for these expenses, the costs would inevitably be passed on to insureds.

State regulation offers valuable impartiality,²⁷² but an administrative body may lack the necessary expertise and current industry knowledge to make the best policy decisions in the insurance context. This can lead to efficiency losses for the industry.²⁷³ There is also a risk of minimal standards being set, which “tend to be couched in vague generalities giving little guidance to what is necessary or desirable to achieve compliance”. These can make industries focus on meeting minimal standards rather than providing customer satisfaction.²⁷⁴ Given that the proposed sanctions are significant, they may be left unused if minimal levels of good faith are sufficient, which would defeat their purpose. These standards are also likely to be less flexible and adaptable to industry change.²⁷⁵

In light of the remedies already available under insurance contracts, clear and convincing evidence should be required to justify such radical, heavy-handed and costly legal change. This conclusion is further justified by the existence of the FIC, which can be modified to achieve the relevant objectives.

VII *Option 5: Reform of the Fair Insurance Code*

The final option is to reform industry standards by amending the FIC. Change would be the responsibility of ICNZ on behalf of its members, so the consensual nature of this reform avoids the undesirability of a third party interfering in private contractual relations. Whilst the industry may be reluctant to further develop its existing obligations, it has an interest in promoting the interests of its consumers and improving its reputation as an industry of good faith. The enhanced credibility of the insurance industry could help to expand demand for insurance products,²⁷⁶ by increasing the public’s trust and confidence in insurers. Reforming the FIC could have marked advantages for the insurance industry in the current climate of public dissatisfaction with insurers.²⁷⁷ This type of reform, as

²⁷⁰ New Zealand Ministry of Consumer Affairs, above n 258 at 4.1.

²⁷¹ Press Council, above n 258 at III.3.

²⁷² Cabinet Office Circular, above n 259 at [14].

²⁷³ New Zealand Ministry of Consumer Affairs, above n 258 at 4.1 and Cabinet Office Circular, above n 259 at [14].

²⁷⁴ New Zealand Ministry of Consumer Affairs (April 1997), above n 258 at 4.1.

²⁷⁵ Press Council, above n 258 at III.3.

²⁷⁶ Neil Gunningham and Joseph Rees "Industry Self-Regulation: An institutional perspective" (1997) 19 *Law & Pol* 363 at 390.

²⁷⁷ See, for example, Parker, above n 3.

opposed to state regulation, gives the industry freedom to create a scheme which fits their unique requirements.

A *Clarifying the Existing Duties*

The FIC presently contains a simple obligation to settle valid claims quickly and fairly. Section 13 of the ICA has been criticised for being similarly vague, and the Consumers' Federation of Australia has submitted that it should include examples of bad faith.²⁷⁸ So, to have more force and clarity, the FIC could explicate possible breaches.²⁷⁹

The FIC could also follow the Australian General Insurance Code of Practice ("GICOP"), which was recently amended to provide specific timeframes for claims-handling.²⁸⁰ These vary with the category of claim and the investigation required, and alternative timelines can be agreed if necessary.²⁸¹ Such provisions would provide greater certainty for insureds and reinforce the security and peace of mind which insurance is meant to provide. They would also set industry benchmarks and give insurers less room to unreasonably delay claims. There is, however, a risk of such provisions reducing incentives for insurers to compete on their efficiency and service standards, so they would need to be set carefully.

The biggest issue facing the FIC is the absence of effective mechanisms for ensuring compliance. The GICOP also demonstrates how this could be improved.

B *Introducing Compliance-Monitoring Mechanisms*

Although the ISO may consider possible breaches of the FIC,²⁸² and can have regard to it in deciding a dispute,²⁸³ it has largely passed its responsibilities to ICNZ.²⁸⁴ This is problematic because ICNZ may simply refer the complaint back to the insurer, without allowing for independent enforcement.

The ISO's powers and duties could be reformed to address these issues, but this would be unsatisfactory. Many cases of bad faith do not proceed to the ISO because they relate to

²⁷⁸ Consumers' Federation of Australia "Submission in Response to the Proposals Paper on Second Stage: Provisions Other than Section 54" at 1.1.

²⁷⁹ For examples of situations where the FIC could be breached, see Chapter 1 at IV.D.3 and the draft statutory provisions for administrative body intervention given in the Appendix to this Dissertation.

²⁸⁰ See "Can the insurers' code changes keep the critics at bay?" (20 February 2012) Insurance News <www.insurancenews.com.au>.

²⁸¹ Insurance Council of Australia "General Insurance Code of Practice" (1 May 2010) <www.codeofpractice.com.au>, cls 3.1-3.4.

²⁸² ISO Terms of Reference, above n 102, cl 5.1(c).

²⁸³ Clause 12.2(d).

²⁸⁴ See Chapter 2 at II.

large claims, or the dispute may be settled privately. Further, the ISO is designed to resolve disputes by deciding the rights and liabilities of each party, and addressing isolated cases may not effectively deter bad faith on a systemic level.

Creating a new compliance-monitoring body could improve the existing system by adding teeth to the FIC's claims-handling obligations. It could also have wider implications for customer interests if compliance with other obligations were checked.

1 *An example: the General Insurance Code of Practice*

The GICOP contains extensive measures to check compliance. If insurers identify a significant breach of their GICOP obligations, they must report it within 10 working days to the Financial Ombudsman Service ("FOS"),²⁸⁵ the Australian equivalent of the ISO.²⁸⁶ Corrective measures, as agreed with the FOS, must be implemented within designated timeframes.²⁸⁷ Additionally, insurers must annually report their GICOP compliance to the FOS and their executive management.²⁸⁸ The FOS monitors and reports insurers' compliance, including the provision of aggregate industry data and consolidated analysis.²⁸⁹

An independent Code Compliance Committee ("CCC") is comprised of a consumer representative appointed by the FOS board, an industry representative appointed by the Insurance Council and a jointly-appointed independent chair.²⁹⁰ The CCC monitors GICOP compliance through FOS reports, may conduct inquiries and may make binding determinations and impose sanctions where an insurer has failed to correct a breach.²⁹¹ It also reports findings and determinations about aggregated breach data.²⁹² Possible sanctions may include: requiring rectification within a specified timeframe; requiring a compliance audit; requiring corrective advertising; and publication of the insurer's non-compliance.²⁹³

²⁸⁵ Insurance Council of Australia GICOP, above n 281, cl 7.3.

²⁸⁶ The FOS decides retail general insurance and small business insurance disputes, inter alia: Financial Ombudsman Service "Terms of Reference" (1 January 2010) <www.fos.org.au>, cl 4.3.

²⁸⁷ Insurance Council of Australia GICOP, above n 281, cl 7.6.

²⁸⁸ Clauses 7.2(b) and (c).

²⁸⁹ Clauses 7.7-7.8.

²⁹⁰ Clause 7.13.

²⁹¹ Clauses 7.14-7.15.

²⁹² Clause 7.16.

²⁹³ Clause 7.22.

2 *What could reform look like?*

Reform of the FIC could be modelled on the Australian approach by creating a similarly-constituted FIC compliance body (“FICCB”) to monitor compliance by ICNZ’s members.²⁹⁴ This scheme could require insurers to report significant breaches to the ISO, and to report its compliance at regular intervals. Dispute resolution schemes would report insurers’ compliance to the FICCB, and customers could complain directly to the FICCB. The FICCB would not be a dispute resolution body, so bad faith in the absence of a valid claim could be considered.

3 *Evaluation*

Better enforcement of self-imposed obligations can positively incentivise compliance because industry participation in its development produces a sense of ownership over its result.²⁹⁵ Industry standards can be raised above minimum legal requirements, which is advantageous in a competitive market which encourages high service levels so that businesses can improve their market share.²⁹⁶

It can also deter bad faith through a spectrum of appropriate sanctions: requiring rectification, a compliance audit or corrective advertising, and publication of the insurer’s noncompliance. The ability to order rectification of non-compliance gives the body a customer-based focus and requires it to consider the relevant harms of bad faith. A compliance audit would be an invasive sanction and, significantly, would enable systemic bad faith to be discovered and addressed. Finally, the possibility of public censure can deter bad faith by influencing customers and thus stimulating market forces. These sanctions can give teeth to the duty of utmost good faith contained in the FIC which, as it presently lacks effective enforcement mechanisms, cannot be truly meaningful. Further, as the FICCB would not be a dispute resolution body, sanctions could reflect the systemic nature of an insurer’s bad faith rather than simply the facts of an individual case.

²⁹⁴ This type of self-regulation is not foreign in New Zealand. For example, the Press Council and Advertising Standards Complaints Board are independent forums for resolving public complaints without a compensatory aim. The Press Council has independent officers and members which represent the public, the Newspaper Publishers Association and others with relevant interests: New Zealand Press Council "Index" <www.presscouncil.org.nz>. The Advertising Standards Complaints Board is similarly constituted of public and industry representatives and adjudicates on complaints: Advertising Standards Authority "Advertising Standards Complaints Board" <www.asa.co.nz>.

²⁹⁵ New Zealand Ministry of Consumer Affairs, above n 258 at 4.2.

²⁹⁶ Taskforce on Industry Self-Regulation *Industry Self-Regulation in Consumer Markets* (Australian Government, Department of the Treasury, 2000) at 24.

With both the ISO and ICNZ appointing the FICCB's members, the body would gain a reasonable level of independence despite its industry funding. The FICCB could then reflect the interests of both the insured and insurer. It would also mitigate the risk of the self-regulation scheme being influenced by the controlling interests of insurers.²⁹⁷ Further, as an expert body, the standards set through enforcing the FIC may be more appropriate and result in greater efficiency than under a state-appointed body. The expertise also allows an informed approach to be taken in applying an otherwise vague obligation. The difficulties in proving bad faith could be also reduced as the FICCB may be well-placed to dismiss otherwise plausible explanations for an insurer's conduct.

The voluntary nature of self-regulation is a significant drawback. Not all insurers in New Zealand are members of ICNZ. However, the vast majority are;²⁹⁸ and membership is incentivised as this accountability could be a significant marketing tool. The other concern is that an insurer faced with a significant sanction could simply withdraw its ICNZ membership and avoid penalty. The Consumers' Federation of Australia has criticised the GICOP in this respect.²⁹⁹ However, such withdrawal can benefit the industry body by ensuring its members are compliant and respect the FICCB's moral authority.³⁰⁰ Further, the media may publicise such withdrawal and thereby stimulate market forces to act against that particular insurer, so the FICCB could still be effective in this respect.

Setting up and maintaining a FICCB could be time-consuming and expensive, and the preparation of reports by insurers could be onerous. However, industry funding is likely to cause a "sharper focus" on cost efficiency than under state regulation.³⁰¹ The costs are also mitigated by the credibility and public trust which the industry could gain through its greater commitment to high service standards.

The final objections are logistical. It would be difficult to check whether insurers were scrupulously complying with their reporting obligations, and the ISO only deals with a narrow range of cases.³⁰² Insurers may also belong to dispute resolution schemes other than the ISO. This may cause inconsistencies depending on which scheme an insurer belongs to, and difficulties in streamlining the schemes' relationships with the FICCB. However, these objections are mitigated by the insured's ability to notify the FICCB of

²⁹⁷ Press Council, above n 258 at III.3.

²⁹⁸ Insurance Council of New Zealand, above n 99.

²⁹⁹ Consumers' Federation of Australia, above n 278 at 4.

³⁰⁰ BusinessNZ, above n 260 at 11.

³⁰¹ Press Council, above n 258 at III.3 and New Zealand Ministry of Consumer Affairs, above n 259.

³⁰² See Chapter 2 at II.

potential breaches, and are outweighed by the public and industry interests in preventing bad faith.

Therefore, improved enforcement of the FIC through a compliance-monitoring body is capable of effectively deterring bad faith on an individual and systemic level. A FICCB has the advantages of avoiding heavy-handed state regulation and being informed by industry knowledge, so efficient outcomes may be more likely. Whilst the costs may be high, the industry will obtain benefits through an improved reputation and increased public confidence. Because of this, a compliance-monitoring body is the best option for enforcing the duty of utmost good faith in New Zealand.

VIII *Conclusion*

Unique issues are created if an insured seeks to enforce the duty of utmost good faith. Because the existing contractual duties provide adequate compensatory remedies and the duty focuses on conduct, its primary role should be to deter its breach. This means the duty should not be addressed through contract law, which does not embrace the function of punishment. Whilst a tortious obligation could fulfil this purpose, the accompanying uncertainty and dependence on individual insureds to pursue litigation means that this option should be dismissed. However, if ICNZ were to reform the FIC's enforcement mechanisms, an accessible expert body could overcome these difficulties and address bad faith in an effective and efficient manner.

Conclusion

Contracts of insurance are designed to provide peace of mind and security for insured parties, and to allow insureds to recover from loss. The fulfilment of these purposes depends on insurers acting in good faith during the claims-handling process; that is, insurers must act fairly, reasonably and honestly when investigating, assessing and settling claims. Bad faith in this process should not be ignored.

The duty of utmost good faith cannot be legally enforced in New Zealand at present. Each possible constraint on insurers falls short either through the content of the relevant obligations, or its enforcement. The FIC essentially requires insurers to act in good faith, but its primary enforcement mechanism (the ISO) is only accessible to some insureds, and complaints seem to be returned to the relevant insurer. Without independent enforcement, the duty of utmost good faith is largely symbolic. Further, whilst contract law may compensate for the harms caused by bad faith, it does not sufficiently deter such conduct.

Because the duty of utmost good faith is a conduct obligation, its enforcement should focus on the insurer rather than any loss suffered by the insured. This means that the duty should be enforced to deter bad faith, rather than to compensate for its effects. That role is already fulfilled by contract law. Whilst this type of enforcement is largely foreign to civil law, it is justified by the insured's special position of vulnerability, and the insurer's financial incentives to abuse its discretion in the claims process.

I contend that bad faith should be addressed through more meaningful enforcement of the FIC. In particular, a code compliance body should be created by ICNZ to monitor insurers' performance, to revive public confidence in the insurance industry. This would avoid the undesirability of a third party interfering with private contractual relations, and punishing non-compliance. Moreover, it could deter systemic bad faith and hold the industry accountable in ways which the judicial system could not.

Therefore, the duty of utmost good faith, which operates so harshly on the insured, could also be used to protect the insured's interests as the balance of power in the relationship shifts. Insurers have assumed these obligations; now, it is time to give effect to them.

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List of Abbreviations

- AFA = Authorised Financial Adviser under the FAA
- ASIC = Australian Securities and Investments Commission
- CCC = Code Compliance Committee (Australia)
- CGA = Consumer Guarantees Act 1993
- FAA = Financial Advisers Act 2008
- FIC = Fair Insurance Code
- FICCB = a hypothetical Fair Insurance Code compliance body
- FOS = Financial Ombudsman Service (Australia)
- FSPA = Financial Service Providers (Registration and Dispute Resolution) Act 2008
- FTA = Fair Trading Act 1986
- GICOP = General Insurance Code of Practice (Australia)
- ICA = Insurance Contracts Act 1984 (Cth)
- ICAB = Insurance Contracts Amendment Bill 2010 (Cth)
- ICNZ = Insurance Council of New Zealand
- IPSA = Insurance (Prudential Supervision) Act 2010
- ISO = Insurance and Savings Ombudsman
- QFE = Qualifying Financial Entity under the FAA

Appendix 1

Draft Statutory Provisions for a Duty of Utmost Good

Faith

X Insurer's duty of utmost good faith when handling claims

- (1) An insurer must act in the utmost good faith in claims-handling, whether or not a claim is covered under a contract of insurance.
- (2) "Claims-handling" includes the exercise of all powers and duties by the insurer and its representatives, and
 - (a) Commences when the insured files a claim with the insurer; and
 - (b) Ceases when the claim has been paid.
- (3) "The utmost good faith" means an insurer must act fairly and reasonably towards its insured, and includes obligations to:
 - (a) Investigate claims fairly and reasonably quickly;
 - (b) Assess claims fairly and without bias, with consideration of all relevant circumstances;
 - (c) Decide whether to accept the claim within a reasonable time;
 - (d) Reach settlements fairly, without using the insurer's economic weight against the insured; and
 - (e) Pay valid claims within a reasonable time.
- (4) A failure to comply with subsection (1) is a breach of the requirements of this Act.

Y Investigation powers of Commerce Commission in relation to breach of good faith

- (1) Any person may complain to the Commerce Commission about a possible breach of section X.
- (2) The Commerce Commission may decide to investigate any action or inaction of an insurer that is, or appears to be, a breach of section X.
- (3) Before investigating a matter under subsection (2), the Commissioner must, by written notice, inform the insurer to whom the investigation relates, of—
 - (a) The details of the complaint (if any) or, as the case may be, the subject matter of the investigation; and

- (b) The right of the insurer to submit to the Commission, within 15 working days of the date of notice, a written response to the contents of that notice.
- (4) The Commerce Commission may investigate under subsection (2) either on complaint or on the Commission's own initiative.

Z Powers of Commerce Commission in relation to breach of good faith

- (1) The Commerce Commission may take any of the actions referred to in subsection (2) if it is satisfied that an insurer has breached section X.
- (2) In any case to which subsection (1) applies, the Commerce Commission may—
 - (a) Censure the insurer;
 - (b) Order that the insurer must pay a fine not exceeding \$50,000;
 - (c) Recommend that the Financial Markets Authority—
 - (i) suspends or cancels the insurer's qualifying financial entity status under the Financial Advisers Act 2008; or
 - (ii) imposes conditions or restrictions on that status.
- (3) The Commerce Commission may exercise its powers under subsection (2) in relation to individual or cumulative breaches of section X.