ASPECTS OF THE LAW OF GOOD FAITH

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Introduction

There is much interesting and important law in relation to the good faith doctrine. Not least in this body of jurisprudence is Justice McMurdo's recent decision in *Lomsargis v National Mutual Life Association of Australasia Ltd*[1] in which his Honour considered the question whether there is a tortious duty of good faith in Queensland insurance law. My paper will deal with some wider issues relating to good faith but, as will become clear, it is in considerable part informed by and indebted to his Honour's thorough analysis.

Good Faith in Contracts

Lord Mustill, in his speech in *Pan Atlantic Insurance Ltd v Pine Top Ltd*[2] pointed out that the celebrated decision of Lord Mansfield in *Carter v Boehm*[3] which is so often identified as the starting point for the doctrine on good faith in relation to insurance, applied the doctrine to all contracts and not specifically to insurance. Lord Mustill observed that the general principle (i.e. in relation to contracts generally) did not prevail but that marine insurance continued to be treated as an exceptional case in which non-disclosure and misrepresentation would ordinarily vitiate the contract even though they would not have had that effect at common law.

So far as concerns the application to contracts in general, English law has not recognised a good faith obligation save in the case of particular kinds of relationships such as fiduciary relationships. This matter was discussed by Justice Finkelstein in *Pacific Brands Sport and Leisure Pty Ltd v Underworks Pty Ltd*[4]. His Honour there referred to a paper by Professor Goode on the subject "The Concept of Good Faith in English Law", which explained that English law takes the view that legal rights can be exercised regardless of motive. The reason is said to be that, according to English

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1 (2005) QSC 199.
2 (1995) 1 App. Cas. 501 at 543.
3 (1766) 3 BURR 1,905
4 (2005) FCA 288 at para [61].

principles of contract law, the predictability of the legal outcome of a case is more important than justice, especially in a commercial setting. As Justice Finkelstein noted, the House of Lords has recently reaffirmed this approach.[5]

In the United States, an opposite position is taken[6]. In Australia the law remains unsettled. In *Pacific Brands* Justice Finkelstein[7] pointed to a number of decisions in Australia, including one or two of his own, which indicate a preference for the position taken in the United States over the more traditional English approach. Citing the decision in *Pacific Brands*, Justice Greenwood, in the Federal Court, recently indicated a preparedness "for interlocutory purposes" to accept that a duty of good faith arose by implied term in a franchise agreement.[8]

The Victorian Court of Appeal has recently had occasion to consider the question of an implied duty of good faith in a commercial context, a joint venture agreement, in *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum NL*[9]. Warren CJ[10] referred to the circular history of the development of the law relating to good faith and concluded that there had been a clear recognition of the doctrine in Australia. But she was of the view that the interests of certainty in contractual activity should be interfered with only when the relationship between the parties is unbalanced and one party is at a substantial disadvantage or is particularly vulnerable in the prevailing context. She said:

> *"Where commercial leviathans are contractually engaged, is difficult to see that a duty of good faith will arise, leaving aside duties that might arise in a fiduciary relationship. If one party to a contract is more shrewd, more cunning and out manoeuvres the other contracting party who did not suffer a disadvantage and who was not vulnerable, it is difficult to see why the latter should have greater protection than that provided by the law of contract."*[11]

Buchanan JA put it this way:

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5 *R (European Roma Rights Centre) The Immigration Officer at Prague Airport (United Nations High Commissioner for Refugees intervening) 2005 2 WLR 1.*

6 See Justice Finkelstein's discussion in *Pacific Brands*, supra at para. [62].

7 Supra at para. [63].

8 *Luce Optical v Budget Specs (Franchising) Pty Ltd* (2005) FCA 1486 at para. [58].

9 (2005) VSCA 228.

10 At paras. [2] and [3].

11 Supra at para. [4].

> *"I am reluctant to conclude that commercial contracts are a class of contracts carrying an implied term of good faith as a legal incident, so that an obligation of good faith applies indiscriminately to all the rights and power conferred by a commercial contract. It may, however, be appropriate in a particular case to import such an obligation to protect a vulnerable party from exploitive conduct which subverts the original purposes for which the contract was made."*[12]

In similar vein, Bergin J, in *Australian Hotels Association (NSW) v TAB Limited*,[13] concluded:

> *"As yet commercial contracts are not a class of contracts that, as a legal incident, have an implied obligation of good faith. As to whether such an obligation is implied otherwise will depend upon the terms of the particular contract and the other matters to which it is permissible to have regard."*

A Duty of Good Faith in Insurance Contracts

So much for general commercial contracts. Our focus, for purposes of this conference is, of course, upon insurance contracts. As Lord Mustill said, the good faith principle did not survive beyond Lord Mansfield's articulation in relation to general commercial contracts but it did survive in relation to insurance contracts. Thus, in insurance, the doctrine enjoys at least a 230 year pedigree. However:

> *"What was never clearly spelled out was how this result (application of a doctrine of good faith to vitiate the insurance contract in cases of non-disclosure and misrepresentation) was achieved. Various theories were advanced: that the policy failed for want of agreement on the subject matter; that non-disclosure was constructive fraud; and that contracts of marine insurance were subject to an implied condition precedent that there had been full and accurate disclosure."*[14]

The importance of understanding and defining the legal derivation of the duty of good faith is shown to us by Justice McMurdo's analysis in *Lomsargis.* His Honour referred to the observation of Badgery-Parker J in *Gibson v Parkes District Hospital*[15] that the duty of good faith and fair dealing was seen not as contractual but as imposed by law once the parties had entered into the relationship created by the contract. Justice McMurdo also referred to Badgery-Parker's J observation that "the mutual duties of good faith to which an insurer and an insured were subject were duties

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12 Supra at para. [25].

13 (2006) NSWSC 293 at para. [78].

14 Lord Mustill, *Pan Atlantic*, supra

15 (1991) 26 NSWLR 9 at 17-18.

imposed by law as an incident of the existence of a contract of insurance but not as implied contractual terms".

This kind of thinking was at the core of the English position, as explained by Justice McMurdo in his discussion of the English cases,[16] that, since a breach of the duty of good faith in relation to an insurance contract did not involve a breach of a term or implied term, there was no remedy in damages but only a remedy by way of avoidance of the contract. (His Honour, of course, had to consider the separate question whether there might be a tortious liability and that is the subject of his Honour's paper given earlier today). Although the good faith obligation might have been understood to be mutual, avoidance as a remedy would likely be of benefit only to an insurer, not to an insured. From an insured's point of view, the constraint upon excessive conduct under the contract by the insurer was doubtless the doctrine's chief advantage.

The position in Australia is, of course, directly affected by s.13 of the *Insurance Contacts Act 1984* which introduces a duty of utmost good faith implied into the contract of insurance as a provision requiring each party to act towards the other with the "utmost good faith".

We are used to seeing cases in which an insurer contests a claim because of an alleged failure on the part of an insured to meet the obligation under the implied term. It has been suggested, though, that the duty has been "significantly under exploited" by insureds[17] and that s.13 can have real significance for the exercise of insurer discretion in insurance contracts and for the way in which insurers administer claims.

In *Australian Associated Motor Insurers Ltd v Ellis & Anor*[18] a comprehensive policy of motor vehicle insurance contained a condition that the insured not make any modification to the car without the insurer's written consent. After the policy had been made and the policy renewed, the insured modified the car by fitting it with "mag" wheels. The vehicle was damaged whilst it was being driving by the insured's 23 year old daughter. The wheels played no part in causing the collision. Cox J, in

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16 *Lomsargis*, supra at paras. 29 – 39.

17 Bremen J *Good Faith in Insurance Contacts – Obligations on Insurers 1999 19 ABR 89*.

18 (1990) 6 ANZ Insurance Cases 60-957.

the Supreme Court of South Australia, found that the insurer was in breach of the implied duty found in s.13 because it had not notified the insured of the consequence of breaching the condition.

This case may be an example of the way in which we might more and more see insureds calling s.13 in aid but we should not overlook the point underlying the strong criticism of that case by Justice Chesterman. He said:

> *"This decision appears to me, with respect, wrong. A duty, the essence of which is to act honestly, is elevated to an obligation in an insurer to coddle its insured and to allow idiosyncratic judicial solicitude to replace principle."*[19]

It is prudent, too, to pause to think about the real content of the duty of utmost good faith. Chesterman J formulated the pre-contracts act duty in this way:

> *"Consistent with what I understand to be the principles of the law of insurance and the nature of the relationship between an insurer and an insured, that it requires good faith from each to the other, there is an implied limitation in any term of a policy which confers rights or powers on the insurer that they be exercised with due regard for the interests of the insured were those interests conflict with the insurers."*[20]

Another formulation is that good faith has generally come to mean "fair dealing in which the one party puts the interests of the other at least at the same level of protection as his or her own".[21]

Examination of the content of the duty pre and post I*nsurance Contracts Act* provides a convenient cross over point to consider the question of honesty.

Honesty

In *AMP Financial Planning Pty Ltd v CGU Insurance Ltd*[22] Heerey J, at first instance, had to consider these facts:

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19 *In the Matter of a Contract of Insurance between Zurich Australian Insurance Ltd and St Andrew's War Memorial Hospital* (1999) 2 Qd R 203 at para. [81].

20 Supra.

21 *Wiltrading (WA) Pty Ltd v Lumley General Insurance Ltd* (2005) WASCA 106 at para. 67.

22 (2004) FCA 1196.

- AMP was a licensed investment adviser. It provided financial planning advice to retail clients though a network of proper authority holders. Those holders were authorised by AMP to give financial advice to clients but only in respect of certain listed financial products as to which the particular holder had been accredited. Two proper authority holders, acting outside their authorities recommended a range of investments to clients negligently and in breach of various securities regulations. A large number of these clients made complaint to ASIC and made claim upon AMP.

- AMP held a professional indemnity insurance with CGU. It notified an intention to claim indemnity in respect of settlements it might have to pay. AMP was under serious pressure from ASIC to quickly resolve the clients' claims and so it developed a protocol for proposed management of the claims which its solicitors submitted to CGU. The solicitors for CGU responded by advising that their client "(had) no difficulties with the claim protocol" but they pointed out that CGU had not yet determined to confer indemnity and the advice was that AMP act "as a prudent uninsured".

- AMP proceeded to settle a number of claims, doing so in accordance with the protocol which included provision of information to CGU regarding liability issues and quantum and other matters.

- Ultimately, CGU refused to reimburse AMP for any of the claims it had settled and refused indemnity for any of those remaining to be settled. AMP brought proceedings against CGU seeking relevant declarations and orders. Its case included an allegation that CGU was in breach of the duty of utmost good faith implied by s.13 of the *Insurance Contracts Act*. In particular, AMP argued that, having represented that it had no objection to the claim protocol, CGU had then acted in breach by failing to respond to requests for instructions pursuant to the protocol, inducing AMP to believe that it was at liberty to proceed, and failing to communicate decisions about indemnity, all of this whilst being aware that AMP was proceeding with the settlements.

His Honour found no breach of the duty implied by s.13 of the *Insurance Contracts Act*. He expressed the view that an allegation of breach of the duty of utmost good

faith requires proof of some want of honesty and made the point that allegations of dishonesty had not been put to CGU witnesses. His Honour relied upon the decision of the Victorian Court of Appeal in *CIC Insurance v Barwon Region Water Authority*[23]. That Authority in turn cites *Kelly v New Zealand Insurance Co Ltd*[24]

No reference was made by his Honour to *Gutteridge v Commonwealth of Australia*, an unreported decision of Justice Ambrose in the Supreme Court of Queensland in 1993. In that case, after a period of delay in investigation and determination of a claim under a fire policy, the insureds sought mandatory orders from the Court that the insurer forthwith admit or reject the plaintiff's claim. They relied, inter alia, upon s.13 of the *Insurance Contracts Act* and the contention that the insurer was in breach of the implied duty to act with the utmost good faith in the consideration and determination of the claim.

Advice was given by the insureds to the insurer that relief would be sought from the Chamber Judge on Tuesday 18 May 1993. At 4.15 pm on Friday 14 May 1993, the insurer's solicitors delivered a letter to the insured's solicitors formally rejecting the claim. It was then conceded by the insured that there was no longer a need for the order but the matter came before Justice Ambrose on an argument as to costs.

Ambrose J said this:

> *"In the circumstances of this case it seems to me that the applicants did have an arguable case to claim the relief which they sought. There is no indication on any of the material that the respondent had any reason to decline to make a decision after a time well before the institution of the applicants' proceedings. The communication of the decision just before the applicant had the opportunity to argue their claim, followed by the appearance of the respondent to contend that they could not have succeeded on the claim even if it had not performed voluntarily what they sought an order that it perform by motion on 18th May 1993, suggests to me that I ought exercise my discretion in favour of the applicants. I am persuaded that in effect it was the applicants' proposed application for relief on 18th May 1993 that led to the communication of the respondent's decision rejecting their claim under their insurance policy. There is no evidence whatever from the respondent to suggest that it had any reasonable justification at all in failing to decide and communicate its decision to the applicants long before it did, by which time the applicants had incurred the expense in bringing their application and were*

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23 (1999) 1 VR 683.

24 (1996) 130 FLR 97.

> *almost at the door of the court. The respondent simply contends that the applicants had no legal right to compel it to decide and communicate its decision but only a right to sue on the assumption that it was in breach of its obligations as insurer in failing to indemnify the applicants' against loss."*

On the subject of the obligation to act with utmost good faith, his Honour said this:

> *"To act 'with the utmost good faith' towards the applicants with respect to their claim under the insurance policy, the respondent was certainly required to act honestly in declining to make a decision with respect to the applicants claim for indemnity upon the destruction of their dwelling house. While the respondent might not fail to act 'in good faith' if it acted honestly although in a blundering or careless fashion, the failure of the respondent to make and communicate within a reasonable time a decision of acceptance or rejection of the applicants' claim for indemnity by reason of negligence or unjustified and unwarrantable suspicion as to the bona fides of the applicants' claims, may constitute a failure on the part of the respondent to act towards the applicants 'with the utmost good faith' in dealing with their claim lodged on 3rd March 1993. Acting with 'utmost good faith' must involve more than merely acting honestly, otherwise no effect is given to the word 'utmost'."*

In the Full Federal Court, on appeal from the decision of Heerey J in *AMP v CGU*[25] the decision was overturned.

On the good faith point, Moore J was of the view that *Kelly* and *Barwon* established that in a case where an insurer claims that the insured has breached the duty imposed by s.13 by failing to disclose relevant information, that failure does not constitute a breach of a duty unless there is some dishonesty attending the non-disclosure. His Honour was of the view that they do not establish, in a case such as the present, that there can be no breach of the statutory duty by an insurer unless the insurer acts in a way that can be said to be dishonest.[26]

Emmett J identified the decision in *Kelly* as going no further than to say that, while an essential element of honesty may be at the head of the concept of utmost good faith, dishonesty is not a prerequisite for a breach of the duty. His Honour, citing Justice Ambrose's decision in *Gutteridge* said:

> *"Putting it another way, acting with utmost good faith involves more than merely acting honestly: otherwise, the word utmost would have no effect. Failure to make a timely decision to accept or reject a claim by an insured for*

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25 (2005) FCAFC 185.

26 See para. 7.

> *indemnity under a policy can amount to a failure to act towards the insured with the utmost good faith, even if the failure results not from an attempt to achieve an ulterior purposes but results merely from a failure to proceed reasonably promptly when all relevant material is at hand, sufficient to enable a decision on the claim to be made and communicated to the insured."*

Giles J dissented in the ultimate decision in this case but not on the good faith point.

Conclusion

As we have seen, the insurance law good faith doctrine is at least 230 years old. Even the express provision in s.13 of the *Insurance Contracts Act* is now more than 20 years old. In one sense, it is surprising that there is not more case law in relation to alleged breaches of good faith by insurers. I suspect the explanation may lie in a point referred to by Justice Chesterman in the *St Andrew's War Memorial Hospital* case that the concept of good faith in general contracts as understood by many of its proponents has found most utility in preserving contracts which the common law might have dealt with by implied terms of reasonableness. What I mean by this is that putting aside its incarnation in insurance law in the insured's duty of disclosure, the concept has, so far as concerns the insurer's obligations, mostly operated as a check on excessive conduct and has mostly been contended for by insureds in conjunction with the propounding of a particular construction of a policy so that judicial consideration of the concept has tended to merge in the resolution of the policy construction issues.

I am not sure that very much has changed or will change because of s.13 of the *Insurance Contracts Act* for the central issue will tend to remain all about getting the claim paid and separate claims for damages or declaratory relief based upon the implied term will be rare.

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