

Claims for Damages Against Insurers in New Zealand

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Introduction

The first thing we learn of insurance contracts is that they are special; unlike other contracts, “An insurance contract is a contract of good faith”. Repeat this often enough and you will approach a trance, in which the duty of good faith appears able to solve almost any insurance law problem. I want to lead you out of this by offering some words of restraint. My words are focused on claims for damages against insurers. I begin, however, with some broader observations on good faith.

Good Faith

There is undoubtedly one respect in which insurance contracts are special: the duty to disclose material facts prior to the contract. There were once good reasons for this special treatment of insurance contracts. Those reasons may have largely disappeared as insurance markets have changed, but in New Zealand at least the duty of disclosure remains.

It is also true that the duty of disclosure, being a duty of openness and honesty, is accurately described as a good faith duty. This is what makes insurance contracts different from other contracts. In other contracts the parties are largely free to keep their cards close to their chests in the contracting process.

However, this special feature of insurance contracts has taken on a life larger than it deserves. Though originally manifesting itself merely as a duty of disclosure, it is now regularly said, and sometimes legislated, that good faith affects the entire contract. While the rationale for the duty of disclosure was always explicit, there has been less explicit articulation of the rationale for this expansion into a generalised duty of good faith.

The existence of a general good faith duty might be supported by pointing to various instances where the courts have recognised a duty of good faith after the formation of the contract. Many of the instances of this “post-formation” duty of good faith are, however, simply mini contracts of insurance. The clearest example is the use by an insured of a held-covered clause. This is subject to the duty of disclosure,¹ but this is hardly

¹ *Liberian Insurance Agency Inc v Mosse* [1977] 2 Lloyd’s Rep 560.

surprising, since the use of the clause provides the insured with cover that it did not previously enjoy. That extension of cover is subject to its own information imbalance.

One instance of a recognised post-formation duty of good faith that cannot be explained as a “mini contract” is the insured’s duty of good faith when making claims. But in this area the courts have, occasionally articulated rationales for the duty. Lord Hoffmann has suggested that here, like the position pre-contract, there is an information imbalance in the insured’s favour, to which the law responds by imposing a duty of honesty.² Maybe. The information imbalance does not have the same consequences, because at the claims stage the insurer is going to do two things that insurers do not appear to do very much at the formation stage: investigate the facts closely, and take their time in making a decision. Another reason that has been suggested is that the contract will not work very well if there is no obligation of honesty upon the insured, as otherwise the insured will have every incentive to lie about and exaggerate claims, knowing that the worst that can happen is that the false part of the claim will not be paid.³ This is probably overstated, as there are many other disincentives to dishonesty in making a claim.⁴

Another instance in which some courts have recognised a good faith duty is in relation to an insurer’s handling of claims. Here some rationales have been articulated, which I shall consider below.

All that these instances show is that for some aspects of the contract there may be convincing reasons for recognising *specific* duties of good faith. This does not provide a rationale for recognising a *general* duty good faith.

Quite often the “rationale” for a general duty of good faith is simply to repeat the mantra that an insurance contract is a contract of good faith. This is problematic because it encourages us to avoid the hard questions. Sometimes we might end up at the same answer, but even if we do, the story that we tell in doing so (whether as adviser, advocate, judge, teacher, or writer) will be incoherent and confusing. And the next time the story is told a further layer or twist will be added.

Finally, for the most part the reliance upon a general duty of good faith is unnecessary. For example, with claims for compensatory or exemplary damages against insurers, a proper application of the ordinary rules of contract damages produces almost the same results as applying damages rules based on duties of good faith. To this I now turn.

Compensatory damages

An insurer who fails to indemnify the insured for a valid claim breaches the contract of insurance. In New Zealand such an insurer is liable to pay to the insured not only the appropriate indemnity, but also damages for breach of contract calculated on ordinary

² *Orakpo v Barclays Insurance Services* [1995] LRLR 443 (CA).

³ *Galloway v Guardian Royal Exchange* [1999] Lloyd’s Rep IR 209 (CA).

⁴ If found out, the insured will find it very difficult ever to obtain insurance again.

contractual principles.⁵ The law is the same in Australia, Canada, and most United States jurisdictions. In England, by contrast, the law does not recognise an additional damages liability.⁶

Pecuniary losses

To recover damages for breach of contract the insured must, of course, prove that the breach has caused some loss. For example, awards have been made where the insurer's failure to indemnify has caused the insured to incur costs in renting alternative accommodation,⁷ or where the insurer's failure has caused the insured to default on loans and incur penalty interest.⁸ Additionally, the insured must show that the loss was not too remote: that the parties would have contemplated the losses as a "not unlikely" result of the insurer's breach.⁹

Non-pecuniary losses

The examples above are of pecuniary loss, which is the sort of loss that contract law traditionally compensates. Recently there has been a move, in the general law of contract, to award damages for non-pecuniary losses. These losses can usefully be divided into two categories: physical inconvenience, and mental distress. Partly because the former category is more objectively identifiable, both contract law in general,¹⁰ and insurance contract law more specifically,¹¹ has been fairly ready to award damages for physical inconvenience.

By contrast, New Zealand is still deciding whether, or when, to provide damages for mental distress for breach of contract, with two positions being adopted in the Court of Appeal. The more restrictive view, in *Bloxham v Robinson*,¹² is that mental distress damages are available only where the object of the contract is to provide pleasure, enjoyment, or freedom from distress. The alternative view, in *Mouat v Clark Boyce (No 2)*,¹³ is that such damages are recoverable in non-commercial contracts. For insurance contract law it may not matter too much which of these views is adopted, because many insurance contracts fit the "freedom from distress" criterion, though usually only in the non-commercial sphere. Thus it is no surprise that there are many examples of awards of

⁵ *New Zealand Insurance Co Ltd v Harris* [1990] 1 NZLR 10 (CA).

⁶ *Sprung v Royal Insurance (UK) Ltd* [1997] CLC 70 (CA). The rationale for the English position is complex, and ultimately unconvincing. For more, see my criticism of the position in [2000] LMCLQ 42.

⁷ *Stuart v Guardian Royal Exchange Assurance of NZ Ltd* (1988) 5 ANZ Ins Cas 75,274; and more recently *Tower Insurance Ltd v Disputes Tribunal at Nelson* (2000) 14 PRNZ 338.

⁸ *New Zealand Insurance Co Ltd v Harris* [1990] 1 NZLR 10 (CA).

⁹ An insured recently failed at this hurdle in *Kleef v Colonial Mutual General Insurance Co (NZ) Ltd* (HC Timaru, AP 6/01, McGechan J, 24 May 2001).

¹⁰ Eg, *Baltic Shipping Co v Dillon* (1993) 111 ALR 289 (HCA).

¹¹ *Edwards v AA Mutual Insurance Co* (1985) 3 ANZ Ins Cas 79,160; *Stuart v Guardian Royal Exchange Assurance Co of NZ Ltd* (1988) 5 ANZ Ins Cas 75,274.

¹² (1996) 7 TCLR 122.

¹³ [1992] 2 NZLR 559.

mental distress damages for an insurer's breach of contract.¹⁴ The Court of Appeal, obiter, has given some approval to such awards, observing that the "mental significance [of late payment by an insurer] may well be within the reasonable contemplation" of the parties.¹⁵

I emphasise here that the recoverability of mental distress damages turns on the type of contract, not on the nature of the insured. In a recent District Court case a claim was made for distress damages by a corporate insured.¹⁶ The judge, dismissing that claim, said "How a legal person which is but a statutory construct could suffer distress in any strict sense of the word was not explained."¹⁷ The explanation is straightforward: in the same way that the law attributes the acts of real individuals to a corporation so that it can be said, for example, that the corporation breached a legal obligation, so the law can attribute the distress of individuals to the company. For most corporate insureds what stands in the way of recovery is that they are party to a hard-nosed commercial contract. But it is common enough for corporations to hold, and insure, assets used for domestic purposes, and in such cases the corporate nature of the insured should not stand in the way of a claim for mental distress damages.

Resort to good faith is not necessary ...

New Zealand law thus provides insureds with fairly complete compensation in the event of an insurer's wrongful declinature. Note that the law has reached this point without resort to the duty of good faith. Insurance law simply reflects and follows the ordinary law of damages. As far as compensatory damages are concerned, it adds nothing to the insured's position to claim that an insurer's wrongful declinature is a breach of the duty of good faith. The wrongful declinature is a breach of contract. That's enough.

... yet

But wait. There is one matter for which compensation in New Zealand does not stretch as far as that in North America. We have heard from Professor Brown that most United States jurisdictions will award damages for a "bad faith" handling of a claim even where the policy does not, in fact, cover the claim. As he observes, these cases implicitly recognise that mishandling a claim is a separate wrong. Canadian courts may go down the same path.

These cases are perfectly defensible, so long as one can defend the basis upon which the "separate wrong" is recognised. The difficulty of that task should not be underestimated. Any separate wrong in this context must depend upon the insurer having an obligation to handle claims in good faith. Where does that obligation come from? Assuming that the

¹⁴ See, eg, *Gaunt v Gold Star Insurance Co Ltd* [1991] 2 NZLR 341; *X v Medical Assurance Society NZ Ltd* (HC Napier, CP 26/98, Ellis J, 18 October 2000)

¹⁵ *State Insurance Ltd v Cedenco Foods Ltd* (CA 216/97, 6 August 1998), p 7.

¹⁶ *Infrapulse Distributors NZ Ltd v State Insurance Ltd* [2000] DCR 170.

¹⁷ At p 187.

insurer has not, in the policy, expressly promised to handle claims in good faith, there are four possible sources of the obligation.

First, one might state that a general duty of good faith underpins insurance contracts, and thus assert that insurers have a duty to respond to claims in good faith. But this simply shifts the question back to “should there be a general duty of good faith?” There is no easy answer to that. Why would one want to solve a fairly confined problem by asking such a large and difficult question? The only reason for doing so, though it is not a very good one, is that one can answer one’s own question with “but an insurance contract *is* a contract of good faith” knowing that many heads will nod in agreement.

Secondly, one might assert that there is a tort obligation to handle claims in good faith. This is just playing with words, because this does not explain why there should be such a tort. I doubt that anyone tries to *explain* the obligation on this basis, though certainly some *categorise* the obligation as tortious. This is generally done out of disrespect to contract law purists, and in some United States jurisdictions because the insured wants to take advantage of more generous damages rules in tort (eg. as to the availability of exemplary damages).

Thirdly, one might argue that, in the narrow area of an insurer’s response to a claim, there are good reasons for *imposing* upon the insurer an obligation to act in good faith. (I emphasise “imposing” there because I am leaving aside for the moment the possibility of a more consensual implied term.) Professor Brown has highlighted one such reason: the vulnerability of the insured. This reason has the advantage of distinguishing insurance contracts from other contracts; in insurance contracts, unlike other contracts, the vulnerability of one party is an almost inevitable consequence of the contract, and almost always lies on the insured.¹⁸ However, that insurance contracts give rise to a unique vulnerability does not tell us how the law should respond to the vulnerability. It is not self-evident that the response should be to impose an obligation of good faith. Some other possible responses are: an obligation merely to pay valid claims; or an obligation to take reasonable care in handling claims.

In asking how the law should respond to insureds’ vulnerability, we should be clear about what is at stake here. There are two scenarios in which it will matter whether an insurer has an obligation of good faith in handling claims. The first concerns the insured whose claim is not, in fact, covered by the policy. As Professor Brown has illustrated, this insured might suffer further losses or inconvenience as a result of the insurer’s delay in validly rejecting the claim. The second concerns the insured who is covered. This insured, we have seen, can make a claim for compensatory damages for losses caused by the insurer’s wrongful declination. But this insured may also suffer losses that are caused, not by the wrongful declination, but by the method of investigation. For example, the insurer’s investigations might invade the insured’s privacy.

¹⁸ This resembles the justification for the duty of disclosure: an information imbalance inevitably results from the nature of the contract (involving a transfer of risk), and the information imbalance is almost always in the insured’s favour.

Next, we should ask what it is that these insureds are vulnerable to. By this I mean what *interests* of the insureds might be affected by the insurer's handling of the claim? This depends on the circumstances of the case. Sometimes the insured's expectations of enjoying certain benefits will be affected, sometimes the insured might suffer further property damage, sometimes some bodily injury, perhaps here and there a bit of false imprisonment. The reason for this enquiry is to remind ourselves that private law (contract, tort, equity, property) is more protective of some interests than others. The law is very protective of bodily integrity, less so of property interests, and largely leaves you to protect your expectation interests through contract. In the more extreme cases that we can imagine of insurer mishandling of claims, there are existing legal mechanisms that provide a remedy to the insured: the torts of false imprisonment, malicious prosecution, defamation, invasion of privacy, trespass, negligent injury to the person, negligent damage to property, and breach of the Privacy Act.

There will of course be cases where these existing mechanisms do not, on the particular facts, provide a remedy. What might we do about these cases? Example 1: the insurer accesses the insured's private information, but this access neither amounts to the tort of privacy nor breaches the Privacy Act.¹⁹ Response 1: if neither tort law nor the legislature thinks that such access is wrongful, and the insurer has not promised to refrain from such access, it is not wrongful. Example 2: the insurer takes longer than the market average to reject the insured's claim for property damage. While waiting to hear the insurer's response the insured refrains from repairing the property, and consequently loses a month's use of the property. Response 2: here the insured is claiming simply for its lost expectation of using its property. Outside certain economic torts, unless the defendant has promised to deliver those expectations, the law does not protect expectation interests. "Vulnerability" is not a recognised ground for protection.

Of course the law is not frozen in time. One might think, for example, that although not presently regarded as important, one person's vulnerability to another should generate an obligation on the other to protect that person's expectations of enjoyment of property. Personally, I'm not convinced, but I am happy to be persuaded otherwise. My essential point is that, if the law is to impose on insurers a separate obligation of good faith in handling claims, it should do so with a close eye on the rest of private law. This is not simply an appeal to consistency. If we ignore broader private law we take no account of the policies that inform it.

To make my point, let me remind you that the path taken by North American courts has been to impose a *good faith* standard on insurers in handling claims. Now, has this standard, rather than, say, a reasonable care standard, been chosen because of its consistency with the norms that inform private law? Or has it been chosen because it has a certain ring to it in insurance law?

Finally on this point, I want to emphasise that I have been focusing on New Zealand law, not Canadian. My impression is that Canadian tort law, for example, is more protective of

¹⁹ This is a purely hypothetical example and for all I know is a legal impossibility: I know nothing about privacy law.

expectation interests than New Zealand tort law. If my impression is correct, the path that Canadian insurance law is taking may not be out of place within the wider Canadian legal landscape.

There is a fourth and final possible source of an obligation of good faith: an implied term. Terms can be implied in two broad ways. Sometimes terms are implied into contracts as a matter of imposition: the courts require that, unless we express ourselves otherwise, we should behave in a certain way. Whether an implied good faith term should be *imposed* simply raises the questions that I have just tried to confront.

The other way of implying terms pays more heed to the consensual nature of contracts: we presume that the parties must have intended the term, because the term is necessary for the contract to work properly (necessary as a matter of business efficacy). I have not seen a convincing argument for an obligation of good faith to be implied on this basis.

Exemplary damages

In New Zealand it remains unsettled whether exemplary damages are available for breach of contract. There have been some High Court awards,²⁰ including an award against an insurer in *Cedenco Foods Ltd v State Insurance Ltd*.²¹ That aspect of *Cedenco* was reversed by the Court of Appeal on the facts,²² but the Court left open whether exemplary damages were available for breach of contract.

There is an extensive literature on the question whether exemplary damages should be available in contract, or even in civil law generally.²³ There is no time here to rehearse the arguments. Suffice to say that, if the law is going to award exemplary damages in one area of civil law (tort), it is difficult to see why it should not do so for at least some breaches of contract.

The more immediate question is whether, if such awards are to be available in contract, there is any reason why they should be more readily available in insurance contracts than in other contracts. Some may offer the duty of good faith as a reason. But, even if the underlying obligation that the insurer has breached *is* based on good faith, it is difficult to see what difference that can make. One might say that a breach of such an obligation is necessarily in bad faith, and therefore meets the exemplary damages requirement of outrageous conduct. That might be true, but the outrageousness or otherwise of conduct can be determined independently of the standard imposed by the underlying obligation.

One reason that exemplary damages might be more available in insurance contracts than in other contracts is that, as a practical matter, “outrageous” conduct might be more easily proved against insurers than against other types of contracting parties. I hasten to add that

²⁰ Eg, *Tak and Co Inc v AEL Corporation Ltd* (1995) 5 NZBLC 103,887.

²¹ (1997) 6 NZBLC 102,220.

²² CA 216/97, 6 August 1998.

²³ For a New Zealand perspective, see Todd, “Exemplary Damages” (1998) 18 NZULR 145.

this is not because insurers' behaviour is worse than anyone else's. Rather, it is because, if New Zealand law does make exemplary damages available in contract, awards are likely to be subject to criteria similar to those used by the Ontario court in *Clarfield*,²⁴ to which Professor Brown referred. The insurance relationship lends itself to many of these criteria being ticked off:

- The reprehensibility of the conduct. Because the insured is in a vulnerable position, it will be easier to call the insurer's conduct toward the insured "reprehensible".
- The profitability to the defendant of the conduct. Wrongful denial of claims will (if undetected) be profitable to the insurer.
- The financial position of the defendant. Insurers are usually in a strong position.
- Any other criminal penalties or civil awards. The insurer's conduct is unlikely to be criminal or subject to other civil awards.

Conclusion

My main aim has been to inject some skepticism into discussions over the role of good faith in insurance contracts. This is important not only in the context of claims for damages against insurers, but equally in areas where arguments are made for additional good faith obligations on insureds.²⁵

²⁴ *Clarfield v Crown Life Insurance Co* (2000) 23 CCLI (3d) 266.

²⁵ Eg, obligations to give notice or information to insurers, additional to the express obligations in the policy. Compare *UEB Packaging Ltd v QBE Insurance (International) Ltd* [1996] 2 NZLR 467 and *GIO Insurance Ltd v Leighton Contractors Pty Ltd* (1996) 9 ANZ Ins Cas 76,305.