CONTRACTUAL POWERS – AN UPDATE

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Hon Justice Stephen Kós[1]

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[1] Contractual powers are a common place in all types of continuous consumer service contracts.

[2] A credit card agreement empowers the bank to alter lending and default rates, and other terms, on notice. An electricity supply agreement with a householder permits the utility to increase its prices on notice, and to enter the householder's property to inspect the meter. A licence permits sub-licences with the consent of the licensor. A construction contract gives the builder flexible options in the event that rock is located where trenches are to be dug.

[3] In the insurance sector a home insurance policy gives the insurer the power to settle the claim by selecting either to make payment, rebuild, repair or replace the home. Or it may confer a power on the insurer or insured to alter terms. For instance, the Tower home insurance policy empowers the insured and insurer to alter the terms of the policy in these terms:

> You can have this policy altered at any time as long as we agree in writing to such alteration before it takes effect. We can alter the terms of this policy by writing to your postal address for this policy on our records and the change will take effect 14 days after the date of that letter from us.

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[1] President of the Court of Appeal. I express my appreciation to my clerk, Duncan Ballinger, for updating research and to Richard Johnstone of Wynn Williams for locating relevant policy wordings.

Another insurance policy provides payment of reasonable architects and surveyors fees to repair or rebuild a home, with the proviso:

> "these expenses must be approved by us before they are incurred".

Or a policy may provide that cover will only apply where the insurer is "satisfied" that the driver of the insured vehicle was free of fault.

[4] These sorts of contractual powers are necessary. It would be unreal for parties to set a fixed framework under the contract and have to renegotiate in the event of foreseeable contingencies that affect risk and reward to an extent that may be uncertain. It would be equally unreal to try to set out all contingencies and consequences at the outset. Consumer contracts need to be brisk, not biblical, in extent. The prospect of variation may be foreseen, but it is usually impractical to articulate that in detail in advance.

[5] I first wrote about this topic in 2012, in an article in the Victoria University of Wellington Law Review.[2] In this speech I take the opportunity to summarise and update what I said then, and to look at contractual powers more specifically in the field of insurance contracts.

[6] One should begin, like an Act of Parliament, with a statement of purpose and then some definition. Having done the first already, I turn to the second. What do I mean by "contractual powers"?

[7] First we should distinguish obligation from power. If a policy of insurance says that in event A, the insurer will do B, that is not a power. It is a contingent obligation. It is a matter of objective analysis whether event A has occurred. And whether the insurer then has done B.

[8] Secondly, most contractual powers occur where the contract simply gives one party a discretion. A choice between options. The power to alter the way in which

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2 Stephen Kós "*Constraints in the Exercise of Contractual Powers*" (2012) 42 VUWLR 17.

the contract is to be performed, or the economic basis on which the original (or altered) bargain is to be performed.

[9] Thirdly, what about an election? The policy says:

> We have the option whether to make payment, rebuild, replace or repair.

For the purposes of this paper I treat a right of election as a power, the exercise of which is reviewable by the Courts. I do so because that is what the Courts have done.[3]

Default rule

[10] The exercise of these contractual powers by one party to the contract may alter the relative benefits and burdens of the contract for the parties. But the law imposes constraints on the exercises of these powers by way of the default rule that a contractual discretion must not be exercised arbitrarily, capriciously or in bad faith, or unreasonably in the sense that no reasonable contracting party could have so acted.

[11] The classic statement of the default rule is in the English Court of Appeal by Leggatt LJ (with whom Balcombe and Mann LJJ agreed) in the following terms in *Abu Dhabi National Tanker Co* v *Product Star Shipping Co Ltd*:[4]

> The essential question always is whether the relevant power has been abused. Where A and B contract with one another to confer a discretion on A, that does not render B subject to A's uninhibited whim. In my judgment, the authorities show that not only must the discretion be exercised honestly and in good faith, but, having regard to the provisions of the contract by which it must be conferred, it must not be exercised arbitrarily, capriciously, or unreasonably. That entails

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3 See, e.g, the discussion of *C & S Kelly Properties Ltd v Earthquake Commission* [2015] NZHC 1690 and *JCS Cost Management Ltd v QBE Insurance (International) Ltd* [2015] NZCA 524 at [31] below.

4 *Abu Dhabi National Tanker Co* v *Product Star Shipping Co Ltd (No 2)* [1993] 1 Lloyd's Rep 397 (CA) at 404.

> a proper consideration of the matter after making any necessary enquiries. To these principles, little is added by the concept of fairness: it does no more than describe the result achieved by their application.

[12] That case concerned a charterparty of a merchant tanker entered at the time of the 1987 Iran-Iraq war. It contained a clause which gave a discretion for the owners to decline to load or discharge where "the loading or discharging of cargo at any … port be considered by the Master or the owner in his or their discretion dangerous" and to direct loading or discharge at another convenient (and safe) port. After four successful voyages between Ruwais in the United Arab Emirates and Chittagong in Bangladesh the owners (without any prior warning) refused to permit loading at Ruwais.

[13] The Court of Appeal applied the default rule against the owners. It found their purported decision to not load at Ruwais was unwarranted. First, the owners could not point to any material on which a reasonable ship-owner could have considered that the risks at Ruwais were greater than they were at the start of the contract. Secondly, the owners were using the contractual power for the collateral purpose of resolving a separate dispute under the charterparty concerning overage insurance.

[14] It is clear from subsequent cases that the threshold prescribed by the default rule is a high one. The decision must be unreasonable in the sense that no reasonable decision maker could reasonably have made the decision on the material before him or her.[5] The decision maker only needs to make the decision in good faith by forming a genuine view after considering the relevant facts and disregarding extraneous considerations.[6] The exercise of discretion must be genuine and rational, not empty or irrational.[7]

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5 *Ludgate Insurance Co Ltd v Citibank NA* [1998] Lloyds Rep IR 221 (CA) at [36].

6 *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd* [2001] EWCA Civ 1047, [2001] 2 All ER (Comm 299 at [67] and [73].

7 *Cantor Fitzgerald International v Horkaluk* [2004] EWCA Civ 1287, [2004] IRLR 942 at [30].

[15] Some common themes exist in the judicial review of public law and private law discretions. But in private law the bargain, and what the parties have paid for, dominates discussion.

[16] An example is *Lymington Marina Ltd* v *Macnamara*.[8] The case concerned a marina licence that permitted sub-licences for periods of not more than 12 months, subject to the approval of the sub-licence by the marina company. The licence-holder sold his yacht and sought to grant sub-licences to his two brothers for short, but recurring, periods. The marina company refused to consent. The High Court Judge concluded that no reasonable marina company could have reached such a decision by reference to the *Wednesbury* decision. The marina company appealed. The Court of Appeal held the High Court Judge should not have used *Wednesbury* principles per se. A term could be implied that the exercise of the power could be set aside if the grounds for refusal were made in bad faith or arbitrarily or if it was based on error. The marina company had mistakenly formed the view it could prohibit rotational sub-licences in the sense the licence-holder had sought to grant. The decision was therefore based on an erroneous view of the power conferred by the contract and was invalid.

[17] The English Court of Appeal's rejection of a *Wednesbury* analysis in *Lymington Marina* is somewhat inconsistent with other decisions in which the Court reasoned by direct analogy to *Wednesbury*.[9] The High Court in New Zealand has held *Wednesbury* unreasonableness is a useful label, but what is required is a contextual and flexible assessment.[10] As I said earlier, it is about the bargain and whether exercise of the power is reasonable given the bargain struck and consideration paid.

[18] Another type of discretion that may be conferred on a contracting party is to vary the terms of the contract. In *Black White & Grey Cabs Ltd v Reid* taxi drivers entered an agreement with a cooperative company on terms which required them to

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8 *Lymington Marina Ltd v Macnamara* [2007] EWCA Civ 151, [2007] 2 All ER (Comm) 825.

9 *Socimer International Bank Ltd v Standard Bank London Ltd* [2008] EWCA Civ 116, [2008] 1 Lloyd's Rep 558 at [66]. *Paragon Finance plc v Nash* [2001] EWCA Civ 1466, [2002] 1 WLR 685 (CA) at [41]. See also *Mallone v BPB Industries plc* [2002] EWCA Civ 126.

10 *Todd Pohokura Ltd v Shell Exploration NZ Ltd* HC Wellington CIV-2006-485-1600, 13 July 2010 at [216].

comply with operating rules laid down by the company from time to time.[11] The company introduced a new rule that prohibited drivers from redeeming taxi chits otherwise than through the company itself (for which it charged 7.5 per cent, whereas other entities had emerged who were happy to do so for less). The Court of Appeal upheld the right of the company to make that change. The amendment was one that could reasonably have been considered to be in contemplation of the parties when the contract was made in light of the nature and circumstances of the contract. The company was a cooperative, operating for mutual profit. It had operating rules, those would be changed from time to time.

[19] The test for whether the power to amend a contract is valid depends, therefore, on whether the amendment could reasonably have been contemplated at the time of contracting. Not *actually* in contemplation but, had they been asked, they would have said, "Yes, that is not unfair". However, the implication of a term restricting the power to amend terms of the contract in that manner depends on the individual contract terms and context, and does not arise automatically.[12]

Limits to the default rule

[20] The default rule of reasonableness is not absolute and will vary in its application with context.

(1) No need to justify objectively the exercise of power

[21] One limit is that the decision maker is not required to objectively justify his or her exercise of power. For example, the Court of Appeal in *Lymington Marina* held that if the marina company had refused, on the basis of some material, to approve a sub-licence on the ground the proposed sub-licencee X's English was poor (giving rise to safety concerns about the ability to understand instructions), then the marina company would not need to undertake further investigations into X's ability

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11 *Black White & Grey Cabs v Reid* [1980] 1 NZLR 40 (CA).

12 *New Zealand Stock Exchange v Listed Companies Association Inc* [1984] 1 NZLR 699 (CA) at 705. This was a case I worked on (but did not appear in) before I went to study at Cambridge. It was that experience 30 years ago which piqued my interest in this subject.

to speak English. Its discretion would not have been exercised unreasonably even if X turned out to be able to speak English well.[13]

[22] Of course, that does not answer the question of whether it would be unreasonable for the marina company to continue to withhold approval if it subsequently received evidence that X could speak English. The Court of Appeal was simply dealing with the initial exercise of discretion to refuse approval to X. That did not have to be justified objectively by an investigation beyond the material made available to the decision maker. The Court noted, however, that it would be capricious for the decision maker to assume an absence of knowledge of English.[14]

(2) No need for decision maker to prefer the interests of the other contracting party to its detriment

[23] The default rule does not require the party exercising power to prefer the interests of the other party. A party may pursue legitimate commercial interests. For instance, in *Socimer* a bank had a power to value assets in the event of a default. The purpose of the power was for the bank to protect its assets. So long as the valuation was made honestly and rationally, the bank was entitled to value the assets conservatively to protect itself from risk. The bank did not need to prefer the interests of its contracting partner to the detriment of its own.[15] That is exactly what parties would have expected at outset of their relationship – when all was rosy and default was a distant nightmare away. Similar conclusions have been reached in contractual "best endeavours" obligations.[16]

(3) Parties may diminish or expand the content of the default rule

[24] The content of the duty to act reasonably must be determined in light of the scheme and express provisions of the contract.[17] If there is a complete written commercial agreement between the parties, it may be problematic to imply an

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13 *Lymington Marina Ltd v Macnamara*, above n 8, at [42]–[43].
14 At [71].
15 *Socimer International Bank Ltd v Standard Bank London Ltd*, above n 9, at [122]–[123].
16 *IBM United Kingdom Ltd v Rockware Glass Ltd* [1980] FSR 335 (EWCA).
17 *Offshore Mining Ltd v Attorney-General* CA116/1986, 28 April 1988 at 23.

obligation of good faith between the parties.[18] So the parties may define, limit or exclude the operation of the default rule.

[25] One case in which the default rule may be excluded is where the discretion is expressed as a "sole" or "unfettered" discretion. For instance, in *Vodafone Pacific* the New South Wales Court of Appeal held a "sole discretion" excluded any constraint on the exercise of discretion.[19] This conclusion was reinforced by other provisions in the contract. For instance there was a distinction between the sole discretion conferred by the clause in issue and other clauses that specified an obligation to act reasonably. There was also an entire agreement clause.

[26] The point should not be taken too far. In *Vero Insurance New Zealand Ltd* v *Fleet Insurance and Risk Management Ltd*,[20] Asher J said that he did not consider "that the words "absolute discretion" necessarily exclude the application of the duty of good faith".[21]

[27] Even if there really is a sole or unfettered discretion conferred, it may be the case that the existence of actual bad faith, or an unlawful or ulterior purpose infecting the exercise of discretion might vitiate the exercise of discretion. That may constitute a fraud on a power.[22] A sole discretion should not permit a wholesale hijacking of the original bargain.[23] All this has been achieved whether any adoption in this country of any generally implied duty of good faith in contractual dealing.[24]

Some important recent New Zealand insurance decisions

[28] There are four cases that touch on my topic. All make recent insurance from the Christchurch earthquakes.

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18 *Savelio v New Zealand Post Ltd* HC Wellington CP143/02, 18 July 2002 at [19].
19 *Vodafone Pacific Ltd v Mobile Innovations Ltd* [2004] NSWCA 15 at [195].
20 *Vero Insurance New Zealand Ltd* v *Fleet Insurance and Risk Management Ltd* HC Auckland CIV-2007-404-1438, 21 May 2007 at [42].
21 See also *Mid-Essex Hospital Services NHS Trust v Compass Group UK & Ireland Ltd*.
22 *Tomlin v Ford Credit Australia Ltd* [2005] NSWSC 540 at [120].
23 *Barton v Air New Zealand Ltd* HC Wellington CIV-2002-485-386, 6 October 2004 at [72]–[107].
24 *Todd Pohokura Ltd v Snell Exploration NZ Ltd*, n 10, at [198].

[29] The most relevant authority is *C & S Kelly Properties Ltd v EQC*.[25] EQC elected to settle by reinstating the plaintiff's house. The plaintiff, seeking a money judgment, challenged the exercise of the power to elect reinstatement. This is a power conferred on EQC by s 29(2) of the Earthquake Commission Act 1993 and provides that where "the property suffers natural disaster damage, the Commission shall settle any claim (by payment, replacement, or reinstatement, at the option of the Commission) to the extent to which it is liable under this Act."

[30] Mander J held, following *EQC v Insurance Council of New Zealand Inc*,[26] that the statutory discretion can be challenged in an ordinary action on the same grounds as a contractual discretion.[27] He summarised the position thus:[28]

> … Commonwealth Courts are willing to intervene in the exercise of a prima facie unfettered discretion. Such intervention will ordinarily be premised on an implied term to constrain the exercise of the discretion so as to give effect to the reasonable expectations of the parties. The exercise of contractual discretion will be open to challenge where it can be established that it was not exercised honestly in good faith; or not exercised for the purpose(s) for which it was conferred; or when exercised in a capricious or arbitrary manner; or otherwise falls into the category of what would be considered *Wednesbury* unreasonableness.

[31] Ultimately the Judge found, *per obiter*, that it had not been shown EQC's election was unreasonable. The challenge was based primarily on an assertion the house required a replacement Type 2A foundation, which the Judge found not to be established on the evidence.

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25 *C & S Kelly Properties Ltd v Earthquake Commission* [2015] NZHC 1690

26 *Earthquake Commission v Insurance Council of New Zealand Inc* [2014] NZHC 3138, [2015] 2 NZLR 381.

27 *C & S Kelly Properties Ltd v Earthquake Commission*, above n 1, at [62].

28 At [73] (footnote omitted).

[32] *JCS Cost Management Ltd v QBE Insurance (International) Ltd* concerned the scope of a business liability insurance policy.[29] The majority of the Court of Appeal concluded the insured's claim was not covered by the policy. Of relevance to the issue of constraints on giving consent, the insuring clause provided indemnity for costs and expenses "incurred with the written consent of QBE in the defence or settlement of any Valid Claim". The majority noted that under this clause:[30]

> It is implicit that QBE would not withhold its consent unreasonably but in order to give its consent, it had to be able to assess the claim as falling within the scope of the insuring clause.

The case is useful in demonstrating that the power to consent or withhold consent is treated in just the same way as other contractual powers.

[33] *Parkin v Vero Insurance New Zealand Ltd* is to similar effect. It considered the following clause from a Vero policy:[31]

> 5. Claims
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> a. On the happening of any event that may give rise to a claim under this policy **you** must:
>
> …
>
> iv. obtain **our** consent before proceeding with repairs (other than for replacement or repair of window glass);
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> …
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> b. **You** shall not without **our** written consent incur any expense or negotiate, pay, settle, admit, repudiate or

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29 *JCS Cost Management Ltd v QBE Insurance (International) Ltd* [2015] NZCA 524.
30 At [44].
31 *Parkin v Vero Insurance New Zealand Ltd* [2015] NZHC 1675.

make any agreement in relation to any claim.

The High Court held consent under cl 5(a)(iv) "may not be [un]reasonably withheld by the insurance company."[32] This was relevant to the Court's conclusion that the insured was entitled to use his own contractors to repair his home and the insurer would then be liable for costs incurred.[33] But that the insured had first to engage with the insurer about scope of work before actually starting repairs.

[34] The insured in *Tower Insurance Ltd v Skyward Aviation 2008 Ltd* owned a red-zoned property with improvements. It sold the land to the Crown and pursued Tower for the physical damage to the improvements. The issue was whether Tower could settle by paying the fair price of another house elsewhere. Skyward said it was entitled to the dollar amount equal to the cost of repair or rebuild. The Tower policy provided materially that it would pay the full replacement value of the house insured on-site or another site or the cost of buying a new home (up to full rebuild cost) – or otherwise indemnity value. And then:

> **we** have the option whether to make payment, rebuild, replace or repair **your house.**

Based primarily on the last sentence I have quoted, the High Court found it was Tower's option how to settle the claim.[34] The Court of Appeal and Supreme Court, in contrast, held that once Tower had elected to make payment (rather than reinstate) it was for the insured to select the basis for making settlement.[35] The reality was actual reinstatement was impossible. Tower should be indifferent to the mechanism by which the insured triggers its right to replacement value recovery.[36] There was nothing in the policy language quoted to suggest Tower has the option first to determine whether "to make payment, rebuild, replace or repair" and

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32 At [40]. The Judge used the term "reasonably" but that is surely a typographical error. See also [47].

33 At [50] and [214(b)].

34 *Skyward Aviation 2008 Ltd v Tower Insurance Ltd* [2013] NZHC 1856 at [36].

35 *Skyward Aviation 2008 Ltd v Tower Insurance Ltd* [2014] NZCA 76, [2014] 2 NZLR 713; *Tower Insurance Ltd v Skyward Aviation 2008 Ltd* [2014] NZSC 185, [2015] 1 NZLR 341.

36 *Tower Insurance Ltd v Skyward Aviation 2008 Ltd*, above n 10, at [28].

then to decide which payment option is adopted.[37] The Court of Appeal also noted that tower had drafted the policy.[38]

[35] Of relevance to the issue of the scope of contractual powers, both appellate Courts noted that if Tower's interpretation was correct then it would have the power to insist on a replacement home being built in another suburb or city despite close connections of the insured. The Supreme Court said Tower's power to do so would be "subject only to arguments about reasonableness".[39]

Some conclusions

[36] Contractual powers are necessary. They are efficient. Contracts cannot predetermine every contingency.

[37] Exercise of a power to alter the form of performance of a contractual obligation can be challenged where the exercise is unreasonable in the sense that no reasonable decision maker could reasonably have made the decision on the material before them.

[38] Some administrative law analogies apply: relevancy, irrelevancy, error of law, for example. But a flexible contextual analysis is needed in which the bargain, and what parties might reasonably have contemplated, is critical.

[39] A term permitting one party to actually vary the contract itself is perfectly permissible. But the power can only be used to the extent the variation could reasonably have been in the contemplation of the parties at the time of contacting.

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37 At [35].
38 At [37].
39 At [34] (CA) and at [37(c)] (SC).

[40] There are limits on the reasonableness default rule. I have mentioned three:

(a) exercise of the power does not need to be justified objectively (although if the exercise is irrational it will be overturned);

(b) the decision-maker is entitled to prefer its own interests; and

(c) the reasonableness rule may be altered by agreement - e.g. an 'absolute discretion' provision - although such a provision is not as effective as it might sound.

[41] The recent Earthquake List judgments are consistent with the preceding principles. But I note the *contra proferentem* rule may be resorted to to restrict the scope of discretions created by policies wholly drafted by the insurer wielding (or attempting to wield) the discretionary power created.