

THE HON JUSTICE A J MEAGHER
JUDGE OF APPEAL, SUPREME COURT OF NEW SOUTH WALES
KENNETH SUTTON INAUGURAL INSURANCE LECTURE
**“THE *INSURANCE CONTRACTS ACT* – GOOD FAITH, CONTRACTING OUT
AND REFUSING CLAIMS”**
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Introduction

- 1 I never had the privilege of meeting Professor Sutton. However, our paths almost crossed at around the time that the first edition of his work was published in 1980. In his preface to that edition, Professor Sutton acknowledges that a considerable part of the book was written whilst he was attached to the Institute of Advanced Legal Studies at the University of London. In that context he makes specific reference to Professor Aubrey Diamond who at the time was the director of that Institute. Professor Diamond also taught insurance law at that university in 1979 and 1980 when I was there as a Masters student.

- 2 Before the first edition of Professor Sutton’s work was published there was, as is noted in the preface, no “suitable textbook” which dealt adequately with the law of insurance as developed in Australia and New Zealand. At that time the sixth edition of *MacGillivray and Parkington on Insurance Law* was the leading English text to which reference was made by both practitioners and academics. By the time the second edition of Professor Sutton’s work was published in 1991, the law of insurance in this country had been significantly changed by the *Insurance Contracts Act 1984* (Cth) and the *Insurance (Agents and Brokers) Act 1984* (Cth). One consequence of the changes introduced by that legislation was that the second edition restricted itself to the law of insurance in Australia. That no doubt was not done lightly.

- 3 Today I propose to consider, necessarily briefly, three respects in which questions remain as to the scope and operation of provisions of the *Insurance*

* I am grateful to my tipstaff, Mr Daniel Farinha, for his assistance in the preparation of this speech.

Contracts Act. They are the good faith provisions in ss 13 and 14; ss 33 and 52, which govern the remedies for non-disclosure and prohibit “contracting out”; and s 54, which is directed to circumstances in which the insurer may not refuse to pay claims.

Utmost good faith

Background

- 4 Section 13(1) has two limbs. The first confirms that the contract of insurance is one of utmost good faith. The second imposes a mutual obligation on each party to the contract to act towards the other, “in respect of any matter arising under or in relation to it, with utmost good faith”. A matter occurring before the contract is made is capable of arising “in relation to it”. Since 2013 (*Insurance Contracts Amendment Act 2013* (Cth)), the Act by sub-ss 13(3) and (4), has extended that mutual obligation of good faith to third parties to whom the benefit of the contract of insurance extends, but only “after the contract is entered into”.
- 5 The most familiar manifestation of the obligation of utmost good faith is the duty of disclosure which arises before the contract is made. The classical formulation of this duty is that of Lord Mansfield in *Carter v Boehm* (1766) 3 Burr 1905 at 1910; 97 ER 1162 at 1164. It is not in terms limited to conduct or non-disclosure by a proposing insured. Lord Mansfield said (at 1909) “good faith forbids either party, by concealing what he privately knows, to draw the other into a bargain from his ignorance of the fact, and his believing to the contrary”. It was however directed to conduct arising before the contract was entered into.
- 6 As the common law subsequently developed, the nature of the contract as one of utmost good faith was a factor informing both the implication of terms and the interpretation of express terms. The purpose of the reforms made by s 13 was to resolve the doubt under the common law as to whether “the duty of good faith applies to all aspects of the relationship between insurer and insured, including the settlement of claims”; and to provide a remedy to an

insured (being the recovery of damages) for loss suffered as a result of any breach of that duty (ALRC Report No 20, Insurance Contracts at para 328). Kirby J summarised the position in *CGU Insurance Ltd v AMP Financial Planning Pty Ltd* (2007) 235 CLR 1; [2007] HCA 36 at [178], noting that “the duty of good faith as between insurer and insured now takes on a true quality of mutuality. It governs the conduct of insurers whereas, previously, as a practical matter, [it] was confined to a duty cast upon insureds because the remedies for proof of the absence of good faith were usually of no real use to the insured”.

- 7 In *CGU v AMP*, the High Court expressed views as to the content of the obligation of good faith. That case involved a “claims made” professional indemnity policy. Considering itself liable to several investors who had not yet made claims, the insured AMP prepared a “protocol” for settling those potential claims. CGU agreed in principle to the protocol, “but advised the insured to act as a prudent uninsured”. The settlements proceeded. AMP sought an indemnity and the insurer denied liability, including on the basis that AMP had not proved that it was legally liable to each of the investors with whom it had settled. In response the insured pleaded an estoppel and also invoked ss 13 and 14, the latter preventing a party from relying on a provision of the contract if to do so would be to fail to act with the utmost good faith. Gleeson CJ and Crennan J (Callinan and Heydon JJ agreeing in this respect) accepted that “utmost good faith may require an insurer to act with due regard to the legitimate interests of an insured, as well as to its own interest” and that the “absence of good faith is not limited to dishonesty”: at [15], [257].

Mutuality requirement

- 8 In their discussion of what might constitute a lack of utmost good faith, Callinan and Heydon JJ suggest, albeit in a qualified way, that an absence of utmost good faith may have elements in common with an absence of clean hands according to the equitable doctrine which requires that a “plaintiff seeking relief not himself be guilty of tainted relevant conduct”. However they also made clear that they were not attempting any comprehensive definition of

utmost good faith or canvassing the range of conduct which might fall within it. Having referred to the circumstances of that case, their Honours concluded (at [261]) that given the insured's haste in settling the claims for its own reasons there was "not such a degree of reciprocal good faith on the part of the [insured] as would entitle it to relief against the insurer".

- 9 The editors of Kelly and Ball, *Principles of Insurance Law* at [4.0270] criticise what they describe as their Honours' "controversial suggestion" that breach of the duty of good faith by one party will disentitle it from asserting a reciprocal breach of the duty by the other party. They note that, even if the duty of utmost good faith is equitable in nature (a doubtful assumption), it now operates as an implied term in the insurance contract so that if both parties are in breach of the term, each would ordinarily have a cause of action for damages. This criticism in my view overstates the significance of their Honours' reference to the equitable doctrine of clean hands and appears not to take sufficient account of the relief being sought by the insured. The policy insured AMP's liability as a licensed securities dealer for acts or omissions of its authorised representatives. The relief sought included that the court hold that CGU's reliance on the requirement that AMP establish its liability in relation to each claim made against it, in circumstances where the protocol had been agreed and implemented, would be to fail to act with the utmost good faith. On that basis s 14 was invoked to prevent CGU's reliance on that part of the insuring clause. In that context, when assessing whether CGU had failed to act in utmost good faith, and whether its reliance on that provision would be to fail to so act, their Honours considered it to be relevant also to assess and take into account the conduct of AMP with which CGU was engaging and responding.

Contracting out

Litigation clauses

- 10 Where a provision of a contract of insurance purports to exclude, restrict or modify, to the prejudice of a person other than the insurer, the operation of the Act, section 52 renders that provision void. Part VIII of the Act regulates the

exercise of the insurer's "rights of subrogation", principally by limiting an insurer's power to bring proceedings in the insured's name against the insured's family members and employees. A clause removing that limitation in relation to the exercise of that right would clearly be void under s 52.

- 11 However what of a clause that expressly creates a new right, resembling subrogation, but purely contractual in nature? There are clauses, described as "litigation clauses", under which the insurer is empowered not only to take over and conduct in the name of the insured the defence of any claim but also to prosecute for the insurer's benefit, and before any indemnity has been provided, claims for damages which the insured has against third parties.
- 12 A view has emerged that rights under such clauses are not rights of subrogation with the result that Part VIII may have no application to them: Andrew Brown, "An Insurer's Rights in Litigation, or Contractual Subrogation: an Oxymoron?" (1996) 8 *Insurance Law Journal* 60; *Owners of the Strata Plan 62658 v Mestrez Pty Ltd* (2013) 17 ANZ Ins Cas 61-961 at 73,263 [86] (Lindsay J); WIB Enright and RM Merkin, *Sutton on Insurance Law* (4th ed, 2015, Lawbook Co), vol 2 at 306-307, referring to the view but not endorsing it. That view proceeds from the proposition, which authority appears now to favour, that the origin of subrogation lies in equitable doctrine, rather than implied term: *Lord Napier and Etterick v R F Kershaw Ltd* [1993] AC 713 at 736 (Lord Templeman); cf. *Hobbs v Marlowe* [1978] AC 16 at 39 (Lord Diplock).
- 13 The conclusion for which this emerging view contends seems incorrect. First, the question whether Part VIII applies to such clauses ultimately is one of statutory construction, and in particular as to the meaning of the words "subrogated" and "rights of subrogation" used in those provisions. An approach which limits the application of Part VIII draws an overly formalistic distinction between modification of the general law right and the express conferral of a right giving the insurer the benefit of the insured's recovery. After all the only sensible justification for the conferral of such a right can be that it is in substitution for and a modification of the right which the insurer

would otherwise have. Secondly, and for the same reason, there is no tension between accepting the equitable nature of subrogation and treating “litigation clauses” as a contractual form of subrogation. Thirdly, the ALRC Report, at para 299 recognises that subrogation can be regulated by an express term in the policy and arises either from an implied term of the contract or from the independent operation of equitable principles. These considerations provide good reason for construing the provisions of Part VIII, when referring to a “right of subrogation”, or to be “subrogated”, as extending to any right of the insurer to exercise in the insured’s name such rights as the insured has against a third party in respect of the subject matter of the insurance, irrespective of how that right arises.

Known circumstances

- 14 Section 33 declares the provisions of Part IV, Div 3 of the Act, which describe the remedies for non-disclosure and misrepresentation, to be exclusive of any remedy for those matters that the insurer has otherwise than under the Act. In the light of that provision and s 52, consider a clause that excludes from a policy all claims arising from any circumstances of which the insured becomes aware prior to the insurance period and which a reasonable person in the insured’s position would consider may give rise to a claim. Critically, such a provision is engaged whether those circumstances are disclosed or not. Does such a clause purport to exclude, restrict or modify the operation of Part IV of the Act to the prejudice of the insured or, which is more arguably the position, would it have that effect? Or is it contrary to the declaration in s 33 that the remedies for non-disclosure in the Act are to be exclusive? Provisions of the kind proposed are common in professional indemnity policies. See for example the policy wording in *CGU Insurance Ltd v Porthouse* (2008) 235 CLR 103 at [5]-[6]; [2008] HCA 30.
- 15 In relation to the operation of s 52, in *Pech v Tilgals* (1994) 28 ATR 197 at 211–2, Dunford J held that such a clause did not restrict or modify or have the effect of restricting or modifying the operation of Part IV. His Honour reasoned that a clause excluding claims notified before commencement would have

nothing to do with non-disclosure. A clause applying irrespective of disclosure should therefore be effective.

- 16 However, in *Permanent Trustee Australia Ltd v FAI General Insurance Co Ltd* (1998) 44 NSWLR 186 at 254 (the argument is set out at 229), Hodgson CJ in Eq observed in passing that if such a clause “had the effect of excluding liability for something which was in substance a non-disclosure, then I think s 33 would in any event prevent the retroactive clause excluding liability.”
- 17 The same point arose on an interlocutory basis in *Macquarie Underwriting Pty Ltd v Permanent Custodians Ltd* [2007] FCAFC 60; (2007) 240 ALR 519. Allsop and Buchanan JJ characterised the contention that such a clause “cannot withstand the effect of s 33” as “arguable” such that the primary judge was right to grant leave for the insurers to be joined as parties (at [28]). Their Honours analogised this issue with the “significant difficulties” encountered in applying s 54 of the Act to “claims-made” policies: see *FAI Insurance Co v Perry* (1993) 30 NSWLR 89; *FAI General Insurance Co Ltd v Australian Hospital Care Pty Ltd* (2001) 204 CLR 641; [2001] HCA 38.

Refusing claims

Restrictions or limitations

- 18 Section 54 looks to the “effect of the contract of insurance” and provides that where but for that section the insurer could refuse to pay a claim by reason of some act or omission of the insured that occurred after the contract was entered into, the insurer may not refuse to pay the claim for reason only of that act or omission. In *FAI v Australian Hospital Care* at [41]–[42], McHugh, Gummow and Hayne JJ, somewhat cryptically, observed that s 54 “does not operate to relieve the insured of restrictions or limitations that are inherent in that claim.” The restrictions or limitations referred to are, looking to the “effect” of the contract, respects in which the insured’s claim does not have an essential characteristic of what is required for cover. In *Maxwell v Highway Hauliers Pty Ltd* (2014) 25 CLR 590; [2014] HCA 33 at [23], the High Court (Hayne, Crennan, Kiefel, Bell and Gageler JJ) further explained that such a

restriction or limitation is “inherent” in the insured’s claim (and fatal to it) if it “must necessarily be acknowledged in the making of a claim, having regard to the type of insurance contract under which that claim is made.”

- 19 Thus the required analysis involves an anterior question, posed at a level of abstraction: what is the nature or essence of the insurance and what are the restrictions and limitations which define it? Or, in the words of the Full Court of the Federal Court (Allsop CJ, Rares and Besanko JJ) in *Watkins Syndicate 0457 at Lloyds v Pantaenius Australia Pty Ltd* (2016) 244 FCR 5; [2016] FCAFC 150 at [40], what is the “essential character of the policy”?
- 20 This analysis will often reduce the relevant question to whether the provision relied on by the insurer – be it in the form of a temporal or geographic exclusion, a condition subsequent or a warranty – defines or describes an essential characteristic of what is insured. At this point examples might assist.
- 21 In *Watkins* the geographic limit of the marine hull insurance was “250 nautical miles off mainland Australia and Tasmania”. However the cover was described as “automatically suspended” where the vessel cleared customs for the purpose of leaving Australian waters and in that event only recommenced when the vessel had cleared customs on its return. That provision, which operated as a temporal exclusion (operating in the same way as a condition), was described by the Full Court at [43] as “a qualification upon the essential cover” and “collateral to the policy’s essential character”. Accordingly the Court concluded at [47] that a “restriction or limitation” that must inhere in the claim, consistently with the essential character of the insurance, was that the yacht be within 250 nautical miles of Australia. The exclusion did not answer that description and accordingly the insurer could not rely on it.
- 22 In *Maxwell* a policy which insured property damage to nominated trucks and trailers excluded damage caused whilst a vehicle was being driven by a person who did not hold a particular driver test qualification. The essential character of the insurance was held not to include as part of its description that at the time of any accident the driver had to hold that qualification.

- 23 The decision of the Queensland Court of Appeal in *Johnson v Triple C Furniture & Electrical Pty Ltd* [2012] 2 Qd R 337; [2010] QCA 282 proceeded otherwise than in accordance with the principles and approach stated in *Australian Hospital Care* and further explained in *Maxwell*. The policy indemnified the owner of an aircraft against legal liability for injury to passengers. An exclusion provided that the insured was not covered whilst the aircraft was being operated in breach of air safety regulations. Although the Court of Appeal held otherwise, that exclusion was not a restriction or limitation which defined the essential character of the policy. Accordingly, s 54 operated to relieve against it.
- 24 In *Prepaid Services Pty Ltd v Atradius Credit Insurance NV* [2013] NSWCA 252; (2013) 302 ALR 732 at [135], I referred to some matters relevant to resolving a question as to the essential character of the policy. They include “the nature of the risk and subject matter insured as well as the commercial or other context in which the insurance is written”. In *Watkins*, the Full Court developed that observation at [41] by noting that the manner in which the parties express themselves will have significant influence. “[C]larity of expression” and designation of “a recognisable body of risk, practically or conceptually distinct” from a broader coverage may suffice to restrict the scope of a policy. Each of those matters might be the subject of evidence directed to the policy’s construction and effect.