

# Materiality, non-disclosure and false allegations: following *The North Star*?

James Davey\*

*The Court of Appeal decision in The North Star shows continuing judicial dissatisfaction with the doctrine of utmost good faith in insurance contract law. As a vehicle designed in the 18th century to counteract inequalities of access to information, it has failed to keep pace with modern circumstances. However, the most recent “hard” case represents an age-old problem: whether to require disclosure of information known by the insured to be untrue, but not yet disproven. This article considers three potential mechanisms for reform: the concept of materiality; the doctrine of inducement and ex post controls on the remedy of avoidance.*

## I. INTRODUCTION

The undeveloped nature of the doctrine of utmost good faith in insurance law has once again come under the scrutiny of the Court of Appeal in *The North Star*.<sup>1</sup> It appears that reform is closer than it has been for some time. Waller LJ began his review of the relevant legal principles by noting “[t]he law in this area is . . . capable of producing serious injustice” and concluded by welcoming the future review of the area by the Law Commission.<sup>2</sup> This focus on legislative interference, rather than judicial reform, was shared by Longmore LJ.<sup>3</sup> Whilst noting the interest of the Law Commission,<sup>4</sup> this paper focuses on the scope for judicial intervention, as the Law Commission has previously called for reform of the doctrine of utmost good faith, with little success.<sup>5</sup>

The facts of *The North Star* raised a series of related but distinct issues as to the limits and operation of the doctrine of utmost good faith. The key facts are relatively simple. At the time of placing the risk, allegations of dishonesty and formal proceedings<sup>6</sup> against one or both insureds were not disclosed. However, the insureds were subsequently either acquitted or the charges were dropped and in one case the key prosecution witness was

\* Cardiff Law School. I am grateful to Professor Richard Lewis and David Glass for their comments on an earlier draft. The usual caveat applies.

1. *North Star Shipping Ltd v. Sphere Drake Insurance Plc (The North Star)* [2006] EWCA 378.

2. *Ibid*, [17] and [20].

3. Both Waller LJ (at [20]) and Longmore LJ (at [54]) welcomed the Law Commission’s proposed review of the area.

4. The Law Commission is undertaking a review of insurance contract law, including non-disclosure. See Law Commission and Scottish Law Commission, *Insurance Contract Law: A Joint Scoping Paper* (2006). A consultation paper is due in 2007.

5. See, eg, Law Commission *Insurance Law: Non-Disclosure and Breach of Warranty*: Law Com No. 104 (Cmnd 8064, 1980).

6. The charges, before the Greek courts, were of involvement in an alleged investment fraud.

prosecuted for bringing false charges. Crucially, these issues were not resolved until after the placing of the risk, but before the insurer sought to avoid the contract.<sup>7</sup> The fundamental question is whether these circumstances constituted a breach of the Marine Insurance Act 1906, s 18, giving the underwriter a continuing right to avoid the contract *ab initio*. It will be remembered that for an insurer to succeed on this basis it must show that a material circumstance was not disclosed, and that the non-disclosure was operative on the decision to contract.<sup>8</sup> Moreover, the right to avoid can be lost, for example by operation of an estoppel. On this basis, three substantive issues can be identified:

1. the materiality of the circumstances, where the allegations were in fact untrue;
2. whether the insurer was induced by the non-disclosure if the insured is found not to be guilty (and *a fortiori* where the chief prosecution witness is later discredited); and
3. is the insurer's right to avoid the contract granted by s 18 restricted, either by the general law of contract, or by the doctrine of utmost good faith, if the insurer has actual or constructive knowledge at the time of avoidance that the allegation was untrue?

The Court of Appeal in *The North Star* was primarily concerned with the first issue of materiality, as inducement was not a ground of appeal and it considered itself bound by its previous decision in *Brotherton (No. 2)*<sup>9</sup> that the right to avoid is not affected by a change of circumstances once the policy is operative. As will be shown, materiality was the weakest of the three grounds for reform, and yet this was the only realistic basis for argument in the higher court. It was no surprise that the decision at first instance was confirmed: that the circumstances were material and ought to have been disclosed. However, it is understood that leave to appeal to the House of Lords has been sought and this paper considers what changes might be made at that level, in light of the concerns of the Court of Appeal.

The search for a just result must respond to a series of conflicting policy considerations. First, there is the assumption of innocence operative in criminal law. This is particularly relevant to allegations of serious criminal conduct, such as those in *The North Star*. However, this needs to be balanced against market considerations: the need to provide the insurer with a fair presentation of the risk. One factor that has been used to bridge this divide is reciprocity, ensuring an even-handed treatment of insured and insurer. Finally comes legal certainty, as it is normally fundamental that parties can establish the legal position with some degree of confidence before seeking to exercise powerful remedies such as avoidance.

This paper proceeds by taking each of the three main elements in turn: materiality, inducement and limits on avoidance of the contract. In Part II, we consider the difficulties that the courts have had in finding a consistent basis for finding untrue allegations of criminality to be material. In Part III, we turn to an examination of the proper limits of inducement on insurance contract law. Finally, Part IV considers the possibility of bars to the use of the remedy of avoidance, under general and insurance contract law.

7. Unfortunately, these matters, and the insurer's knowledge at the moment of avoidance, were not tested in the High Court and the Court of Appeal refused to consider issues that would require further evidence before the High Court to resolve. See [2006] EWCA 378, [13], *per* Waller LJ.

8. For a detailed review of the doctrine of utmost good faith, see H Bennett, "Mapping the Doctrine of UGF in Insurance Contract Law" [1999] LMCLQ 165.

9. *Brotherton v. Aseguradora Colseguros SA (No. 2)* [2003] Lloyd's Rep IR 746.

## II. NON-DISCLOSURE, MATERIALITY AND ALLEGATIONS OF CRIMINALITY

The seemingly straightforward question as to the likely materiality of allegations of serious criminality has troubled the courts. This may be due to the range of different policy factors and legal issues that are relevant. There are at least four potential factual circumstances under consideration in the case law that follows. First, we have the case where the allegation is shown to be false prior to contracting. Even this simplest of situations remains problematic in the eyes of the judiciary, particularly if it is a perverse acquittal. The second is where the allegation is disproved after contracting but before avoidance. This is the instant case, *The North Star*. The third is where the allegation is shown to be untrue between the moment of avoidance and the moment of trial. Finally, we have the situation where the proposer has an unresolved allegation of criminality at the time of contracting, and this would otherwise remain unresolved up to and beyond the point of judicial resolution of the insurance dispute. Across this range of circumstances, a single question arises: should the insurer be entitled to resile from its contractual promises if the allegation was not disclosed on contracting?

### **A. The materiality of criminal allegations: the orthodox view from *Lynch v. Dunsford to The North Star***

The interlinking of questions relating to the time at which materiality is assessed, the evidence that can be considered and the relationship between the position as known to the parties and the “true” position has led to inconsistency in approach and result. It is well established that the character of the insured (and its employees) may be material to the risk insured as part of the “moral hazard”. That is a matter of fact in each case. However, there is a lack of coherence in the approach of the courts. This may be due in part to the shifting nature of the test for materiality, as cases prior to *Pan Atlantic*<sup>10</sup> adopted a number of different formulations as to the proper test to be applied.<sup>11</sup> However, there is a further substantive difficulty of principle. The courts have not been consistent as to whether the insured can ever be taken to be “innocent” or “guilty” of any offence.<sup>12</sup> Given that the result of a criminal proceeding is not binding on future civil proceedings (whether acquittal or conviction),<sup>13</sup> the verdict has sometimes only been viewed as a presumptive result, subject to challenge by insured or underwriter. On this basis, the only verifiable fact is the allegation of criminality and not the verdict, and it is from this that the allegation derives its materiality. Other judges have taken the view that unless challenged, convictions or acquittals are definitive, and that allegations are normally immaterial. This,

10. *Pan Atlantic Ins v. Pine Top Ins* [1995] 1 AC 501.

11. In this context, see *March Cabaret Club v. London Assurance* [1975] 1 Lloyd’s Rep 169, 175 and *Lambert v. Co-Operative Ins* [1975] 2 Lloyd’s Rep 485.

12. As noted by R Gay, “Non disclosure and avoidance: lies, damned lies and intelligence” [2004] LMCLQ 1, 2, probability can apply retrospectively, in the sense of assessing the evidence that something did happen, rather than something will happen. The contrary view would state that, whatever the available evidence of the event, it either did happen or it did not.

13. On the limited evidential nature of the resolution of allegations of criminality, see *Gray v. Barr* [1970] 2 QB 626 (acquittal) and *Dunbar v. Plant* [1998] Ch 412 (no charges brought); and on convictions see Civil Evidence Act 1968, s 11.

combined with uncertainty as to the cut-off point for admissible evidence on materiality, has led to a degree of fragmentation and inconsistency.

### 1. *Materiality and allegations of dishonesty*

In attempting to map the judicial approach to moral hazard, we begin with the orthodox view. This can be traced back at least as far as the early 19th century.<sup>14</sup> From a reading of the cases, the standard view of both materiality and inducement is that they are tested according to the circumstances as known at the time of placing the risk. As Colman J put it in *The Grecia Express*,<sup>15</sup> “it is quite clear from s 18 of the Marine Insurance Act 1906 that the attribute of materiality of a given circumstance has to be tested at the time of the placing of the risk and by reference to the impact which it would then have on the mind of a prudent insurer”.

On this basis, even if an undisclosed fact is later proven to have been irrelevant to the risk run, this is seen as of no consequence, because the insurer was not given the benefit of considering or investigating the uncertain issue on placing. Of the four factual situations noted above, only acquittal before placement renders the fact immaterial, and then only when the acquittal is justified. Early support for this approach can be found in *Lynch v. Dunsford*,<sup>16</sup> where Lord Ellenborough CJ had to consider the non-disclosure by the agent of the ship's name at a time when a ship of that name was known to be in distress. Ultimately, the information relating to the vessel was shown to be false. Lord Ellenborough made clear<sup>17</sup> that “the duty of the assured or his agent in making such communications of material circumstances within their knowledge must attach at the time of effecting the insurance, and cannot depend upon the subsequent event”.

On this basis the ultimate truth (or otherwise) of the information was unimportant, and the non-disclosure was operative. The zenith (or perhaps nadir) of the former view is found in a *dictum* of Morison J in *Brotherton (No. 3)*.<sup>18</sup> . . . “I regard it as blindingly obvious that the fact that an allegation of misconduct against the president of the insured has been made is a potentially material fact quite independent of the truth of the contents of the allegation.”

A distinction has developed between circumstances known only to the insured, and allegations made by third parties. In *The Grecia Express*,<sup>19</sup> Colman J explained this approach by reference to the following hypothetical situations:

(1) allegations of criminality or misconduct going to moral hazard which had been made by the authorities or third persons against the proposer and are known to him to be groundless;

14. In addition to those cited elsewhere, see *Da Costa v. Scandret* (1723) 2 P. Wms. 170, *Durrell v. Bederley* (1816) Holt, N.P. 283 and *Shirley v. Wilkinson* (1781) 3 Dougl. KB 41.

15. *Strive Shipping Corp v. Hellenic Mutual War Risks Association (Bermuda) Ltd (The Grecia Express)* [2002] Lloyd's Rep IR 669, [281].

16. (1811) 14 East 494; 104 ER 691.

17. *Ibid.*, 692.

18. *Brotherton v. Aseguradora Colseguros SA (No. 3)* [2003] EWCA Civ 705; [2003] Lloyd's Rep IR 762, [4].

19. [2002] Lloyd's Rep IR 669, [282].

(2) circumstances involving the proposer or his property or affairs which may to all outward appearances raise a suspicion that he has been involved in criminal activity or misconduct going to moral hazard but which he knows not to be the case;

(3) circumstances involving him or his business or his property which reasonably suggest that the magnitude of the proposed risk may be greater than what it would have been without such circumstances.

He considered that example (2) was not within s 18, as this would require “that the assured should evaluate for himself perfectly innocent facts to see whether they might be misconstrued by an underwriter as indicating his dishonesty”.<sup>20</sup> However, hypothetical (1) was in his view material, even if the insured knew itself to be innocent of the offence. Moreover, the third situation was also viewed as material. Colman J gave a reasoned analysis of the nature of materiality, stating:<sup>21</sup> “that which invests the circumstances with materiality is emphatically not the existence of the *suggested* facts, but the existence of the *known* facts, for the underwriter is entitled to take into account the *risk* that the *suggested* facts may be true and the proposer is not entitled to deprive the underwriter of that opportunity because he personally believes albeit he does not know for certain that the *suggested* facts are untrue.”

This echoes the *obiter* comments of May J in the *March Cabaret Club* case<sup>22</sup> that a pending prosecution, particularly for an offence involving dishonesty, would normally be material, even if the defendant were in fact innocent. Phillips J, in *The Dora*,<sup>23</sup> expressly supported the approach of May J in *March Cabaret Club*, although his statements were also *obiter*. Phillips J considered that even unfounded allegations should be disclosed, because they should not be judged with the benefit of hindsight, and the insurer was entitled to know of unresolved matters at the time of placing.

This approach has received some support from the appellate courts, including Mance LJ in *Brotherton (No. 2)*. In considering materiality in light of a perverse acquittal or conviction, he stated: “Since what is material depends upon what would influence the judgement of a prudent insurer at the time of the placing, both the (known) fact of guilt, in the case of an acquittal, and the (known) fact of a conviction, in a case where the insured himself knows that he is innocent, may be capable of being material to a prudent insurer.”<sup>24</sup> On this basis, materiality is established by one of two factors. Disclosure is triggered either by the third party’s verifiable allegation (even if the insured subjectively knows this to be untrue) or by the insured’s own knowledge of risk increasing circumstances that are not generally known.

However, this clear line has become blurred. Waller LJ, in *The North Star*,<sup>25</sup> was of the view that, unless the insured had clear proof that the allegation was unfounded (he described the case where the allegation is withdrawn because the complainant admits to “a terrible mistake as to identity”), the underwriter was entitled to disclosure of the

20. *Ibid.*, [284].

21. *Ibid.*, [285] (emphasis in original).

22. *March Cabaret Club v. London Assurance* [1975] 1 Lloyd’s Rep 169, 177, *per* May J: “*Had it been material* I would have been prepared to hold in this case that in any event [the director of the insured company] ought to have disclosed the fact of his arrest, charge and committal for trial at the date of renewal, even though in truth he was innocent” (emphasis added).

23. *Inversiones Manria SA v. Sphere Drake Ins (The Dora)* [1989] 1 Lloyd’s Rep 69, 93.

24. [2003] Lloyd’s Rep IR 746, [23].

25. [2006] EWCA 378, [35].

allegation. This would seem to give further credence to the orthodox view that the insured's personal knowledge of its innocence cannot act as a justification for non-disclosure, except perhaps in the clearest of cases. The difficulty lies in defining the limits of these "clear cases". Gay has suggested<sup>26</sup> that the line is where the insured knows, rather than merely suspects, the report to be groundless. However, he gives a further restriction: that, where the accusation is about the insured's own conduct, then an objective test (from the perspective of the reasonable proposer) is to be added.<sup>27</sup> Midwinter takes a similar line, but without the caveat for allegations of dishonesty:<sup>28</sup> "the insured is only excused from disclosing facts which he positively *knows* not to be true. A mere belief in the falsity of a rumour or report or allegation is not enough, however strong or well-founded that belief may be, because it remains *possible* that the rumour, report or allegation is true and the insurer is entitled to consider the matter for himself."

What we have here are a series of concentric circles seeking to describe the limited circumstances in which disclosure is not required. What is absent is any consistent or binding guidance on the precise limits. Given the Draconian consequences of not disclosing, even honestly, this lack of legal certainty is regrettable. Otherwise, what the insured must do is disclose, and seek to persuade the underwriter that the allegation is baseless. This, as will be shown, is no easy task, as insurers do not seem predisposed to listen to such pleas.

## 2. *Disclosure as a reactive process*

Since the landmark decision in *Pan Atlantic*<sup>29</sup> the courts have recognized that disclosure is a reactive rather than a static process. The response of the prudent (and, as shown later, the actual) underwriter is assessed not at some single point of disclosure, but after an imagined further period of negotiation between the parties. The seed for this is in *Brotherton (No. 2)*:<sup>30</sup> "the issues of both materiality and inducement would in all likelihood fall to be judged on the basis that, if there had been disclosure, it would have embraced *all* aspects of the insured's knowledge, including his own statement of his innocence and such independent evidence as he had to support that by the time of placing."

In developing this into a fully considered *obiter* discussion of the limits of materiality, Rix LJ in *Drake Insurance v. Provident Insurance*<sup>31</sup> stated: "When account has to be taken of a non-disclosure, the issue moves from the world of actual fact into the world of hypothesis. The non-disclosure is the actual fact, and the hypothesis is what effect disclosure would or might have had on a prudent underwriter (the issue of materiality) and what effect disclosure would have had on the actual insurer (the issue of inducement). I do not at present see why the hypothetical world is one in which the insured is assumed to have made the disclosure but not assumed to have provided true information about the settlement of the earlier accident as a no fault accident."

26. [2004] LMCLQ 1, 4.

27. *Ibid.*, 5.

28. SB Midwinter, "The duty of disclosure and material rumours" [2003] LMCLQ 158, 163.

29. [1995] 1 AC 501; *supra*, fn 10.

30. [2003] 1 Lloyd's Rep IR 746, [22].

31. [2004] Lloyd's Rep IR 277, [74].

What is clear in its application in *The North Star* is the context specific nature of this test. In *Drake v. Provident*, there was an expectation in respect of the motor insurance market that there would follow an extended period for further disclosures. By contrast, at first instance in *The North Star*,<sup>32</sup> Colman J appeared unconvinced that in the marine war risks market the prudent underwriter would find time to consider further information. The difficulty this causes a putative insured were expressly remarked upon by Waller LJ in the Court of Appeal:<sup>33</sup> “unless the material is such as to prove beyond peradventure that the allegation is false, in which event the allegation seems to me no longer material, an underwriter is not likely to be prepared to take time sorting out the strength or otherwise of the allegation. In many instances he would be likely to take the view there is no smoke without fire and turn the placement down or at the very least rate the policy to take account of the allegation.”

To succeed in cases such as *The North Star*, the court would need to be persuaded that an allegation would lead to a full and frank exchange of views with the prudent insurer, following which the insurer would be persuaded of the insured’s innocence, or at least that such information was no longer material. However, as seen below, the reported expert evidence from the underwriters is that the prudent underwriter will often refuse to insure anyone charged with dishonesty. The pragmatic process of negotiation imagined in *Drake v. Provident* is unlikely to be replicated in cases concerning allegations of fraud. The *North Star* scenario would seem to fit the hypothetical case (based on *Lynch v. Dunsford*) considered by Rix LJ in *Drake*. In considering the potential materiality of a false report of unseaworthiness where the insured knew the vessel was sound, he said: “even if the underwriter had been informed of the cargo owner’s knowledge, he would still have been in a position where he had two inconsistent reports about a vessel at sea with no way of testing between them until further information which he could consider wholly reliable had become available to him.”<sup>34</sup>

Even though the approach to materiality appears to be shifting, the market context in *The North Star*, at least as described by Colman J, would appear to render the undisclosed allegations material. We now turn to a critical assessment of this line of authority, and explore an alternative approach.

## **B. Materiality, certainty and reciprocity: doubts about the orthodox rule**

There are three substantial areas of doubt here. First, the line of authority from *Lynch v. Dunsford* is less clear than stated in many of the cases. Secondly, there is an alternative approach evident in the *Reynolds* case,<sup>35</sup> and that appears to be a direct comparator to *The North Star*. Given Waller, Longmore and Rix LJJ’s stated views that the doctrine of utmost good faith may need to be revised<sup>36</sup> to prevent the possibility of bad faith avoidance, these provide exemplars for judicial reconsideration of materiality. Finally, we note the potential for reciprocal disclosures: if the duty of disclosure is mutual, should not insurers be

32. [2005] 2 Lloyd’s Rep 76, [256].

33. [2006] EWCA 378, [17].

34. [2004] Lloyd’s Rep IR 477, [73].

35. *Reynolds v. Phoenix Assurance* [1978] 2 Lloyd’s Rep 440.

36. *Drake Insurance v. Provident Insurance* [2004] 1 Lloyd’s Rep IR 277, [87] per Rix LJ; *North Star Shipping Ltd v. Sphere Drake Insurance Plc (The North Star)* [2006] EWCA 378 (CA), [20], per Waller LJ, [54], per Longmore LJ.

obliged to disclose to all potential customers that they are under investigation from the Financial Services Authority or other authorities?

### 1. *The limits of Lynch v. Dunsford*

In *Brotherton (No. 2)*,<sup>37</sup> Mance LJ saw himself as upholding a line of authority from *Lynch v. Dunsford*<sup>38</sup> to the present day. However, as noted above, many of the comments at first instance were *obiter*; and they overlooked the ratio of the decision in *Reynolds v. Phoenix Assurance*<sup>39</sup> (a decision which is considered in more detail below). Moreover, the line of argument from *Lynch v. Dunsford* can be distinguished,<sup>40</sup> as in *Lynch* neither party knew if the information was true or false. It is less controversial to require disclosure in such circumstances. To borrow from Donald Rumsfeld,<sup>41</sup> it was a “known unknown”. The insurer is entitled to discover what areas of uncertainty are known (or to more accurately reflect s 18, to be told of those that are known or ought to be known) to the insured. By contrast, in cases where an allegation of serious personal criminality is made, the insured is likely to know the veracity of the allegations.<sup>42</sup> To be clear: it is not whether the insured will be convicted that increases the risk, it is whether the offence was actually committed. Using this to extend Mance LJ’s reasoning, the (known) fact of innocence would displace the other known facts as material circumstances. Similarly, in response to Colman J’s statement on materiality:<sup>43</sup> what would divest the allegation of its materiality is the known (to the insured) fact that the insured is innocent. As we will see below, the fact of acquittal or conviction is commonly seen as providing a presumption of guilt or innocence for the civil tribunal. On this basis, the only “true” position that materiality can be judged against is whether the insured actually committed the offence. If the insured knows the accusation is baseless, it ought not to be material.

If this approach were adopted, the insured would have to make a choice. If it knows it is innocent, and the allegations are unfounded, then it can keep the allegation to itself, unless specifically asked by the insurer. If it does not know whether the allegations are correct, either because it does not yet know the full facts or it does not know the full legal position, then it should disclose the allegation. As Bayley J stated in *Lynch v. Dunsford*:<sup>44</sup> “As to the assured taking the chance of the event upon himself; he did not tell the underwriters of the fact within his knowledge, and that *he was willing to take that chance upon himself, but he took the chance of their finding out his knowledge of the fact, if it afterwards turned out to be true.*”

37. [2003] Lloyd’s Rep IR 746.

38. (1811) 14 East 494; *supra*, fn 16.

39. [1978] 2 Lloyd’s Rep 440.

40. See the treatment of Rix LJ in *Drake v. Provident*, *supra*, text to fn 31.

41. “The message is that there are known knowns—there are things that we know that we know. There are known unknowns—that is to say, there are things that we now know we don’t know. But there are also unknown unknowns—there are things we do not know we don’t know. And each year we discover a few more of those unknown unknowns.” See Donald H Rumsfeld, US Secretary of Defence, Press Conference, NATO Headquarters, Brussels, Belgium, 6 June 2002. Archived at <<http://www.defenselink.mil/Transcripts/Transcript.aspx?TranscriptID=3490>>.

42. This might not always be the case. The insured may know of the facts, but be ignorant of the law, particularly where it is operating in a number of jurisdictions.

43. *Supra*, text to fn 21.

44. (1811) 14 East 494, 498; 104 ER 691, 692 (emphasis added).



This quotation has been cited extensively, but not fully explained.<sup>45</sup> It does not merely support the notion that the insured takes the risk that the insurer will discover that there is an undisclosed report. This misses the last part of the sentence “if it afterwards turned out to be true”. A true reading of this suggests a test based on hindsight, with the ultimate veracity of the statement as the determining factor.<sup>46</sup> It may be that the view of Lord Ellenborough CJ is more persuasive, but *Lynch v. Dunsford* is not the clear authority it is represented to be.

Returning to the concept of a “known unknown”, this can be used to explain the difference noted by Clarke<sup>47</sup> that we are generally obliged to disclose the opinions of medical professionals but not family members as to our state of health. In the case of the specialist, it is assumed that he knows more than we do and that state of uncertainty ought to be disclosed. Where the information is known by the insured to be untrue, or not founded on a reasonable basis, then it ought not need to be disclosed. If Colman J and Mance LJ’s analyses were taken to extremes, then any reckless or deliberately false (and thereby fraudulent) misrepresentation would need to be repeated to the insurer. This surely goes beyond the natural limits of the principle established in *Carter v. Boehm*<sup>48</sup> to ensure a fair presentation of the risk. Insurers remain free to make specific enquiries or to seek express contractual clauses to protect their interest in the same fashion as other contracting parties

## 2. *The Reynolds view: an hierarchy of norms*

A conflicting analysis of materiality was provided in *Reynolds v. Phoenix Assurance*.<sup>49</sup> Forbes J considered that the only factor that would be normally material to the magnitude of the risk would be the commission of a relevant offence. Thus, a conviction is only material as evidence of the commission of the offence, and he recognized that the insured would still have to disclose relevant criminality if acquitted at trial, or even if the prosecuting authorities were unaware of the offence. This develops the view, taken above by Colman J, that it is normally the facts within the insured’s knowledge that determine the materiality of the allegation. However, it extends it to the knowledge as to the insured’s guilt or innocence. On this basis, the only time when an allegation would not be superseded in significance by the actual commission of the offence is when the insured is in fact innocent. It would be the most pertinent circumstance not diminishing the risk. By focusing on the commission of the offence in this manner, Forbes J raised doubts whether untrue allegations would ever be material:<sup>50</sup> “It follows, if [counsel for the insurer] is right, that the only occasion on which the allegation, as an allegation, must be disclosed is when it is not true. This appears to me to be a conclusion so devoid of any merit that I do not consider that a responsible insurer would adopt it . . .” This is an attractive

45. See *Drake v. Provident* [2004] Lloyd’s Rep IR 277, [73], per Rix LJ

46. This conflicts with the opening statement of his judgment: “The assured’s agent is blameable, not for not communicating the rumour, but for not communicating to the underwriters a fact material with reference to that rumour, which fact was within his knowledge, so as to enable them to apply it to the rumour, and exercise their judgment accordingly.” (1811) 14 East 494, 498; 104 ER 691, 692.

47. MA Clarke, “Refusing Rescission: Contracts of the Utmost Bad Faith” (2003) 62 CLJ 556, 557.

48. (1766) 3 Burr. 1905.

49. [1978] 2 Lloyd’s Rep 440.

50. *Ibid.*, 460.

analysis. It creates an hierarchy of materiality, with the lesser circumstance (eg, arrest) superseded as a material fact by more significant developments (such as acquittal).<sup>51</sup> To operate such a test requires the assessment of materiality to shift from the moment of placing the risk to the moment of avoidance. However, as noted below, courts have frequently used hindsight in this manner.<sup>52</sup> On this basis, the allegation of criminality is immaterial if it is untrue because *to the knowledge* of the insured it does not create any additional risk for the insurer. If this belief is confirmed before avoidance, then the underwriter has received a fair presentation of the actual risk. This added caveat to Forbes J's approach overcomes the objections made by Mance LJ and others as to the early case law on rumours on intelligence. *Lynch v. Dunsford* deals with a case where neither party would have known of the truth of the statement. Moreover, of the 20th century cases considered, only Forbes J's analysis in *Reynolds* is ratio, and yet this appears to have been overlooked by many commentators.<sup>53</sup> As a precedent, *Reynolds* has been superseded by *Brotherton (No. 2)*<sup>54</sup> but it does provide an alternative basis for the House of Lords to consider should reform of materiality be desired.

The attractiveness of Forbes J's analysis is that it is consistent with the true purpose of the rules on non-disclosure: to provide a minimum level of protection for underwriters. Like other commercial operators, they can bargain for greater protection by means of express contractual clauses or rely on the doctrine of misrepresentation. This would be consistent with the approach of the Court of Appeal in *Economides*,<sup>55</sup> that the insured was not obliged to further investigate the risk on behalf of the insurer. If the insured knows itself to be innocent, why must that fact be considered irrelevant unless proven, whereas suggestions of criminality are relevant unless disproved? Ultimately, Mance LJ is reliant on a flat hierarchy of circumstances where all issues are equally disclosable, with the insurer entitled to judge the risk on the worst-case scenario. Forbes J and others have a more structured approach, with lesser facts being displaced by those of greater significance.

The orthodox judicial comment that an insurer would find itself in a potentially compromised position unless full disclosure is forced under s 18<sup>56</sup> ignores the routine handling of past convictions and allegations of criminality by other financial institutions and employers. Indeed, niche markets have been created to deal specifically with those who require finance despite "County Court Judgments" (as they are routinely termed) being made against them. What is noteworthy in this context is the lack of reported underwriter experience on handling disclosed allegations and convictions.<sup>57</sup> Forbes J considered this at some length in the *Reynolds* case, before deciding that the allegation was not material. He noted:<sup>58</sup>

51. This is consistent with the approach of the Rehabilitation of Offenders Act 1974, s 4(3)(a): "any obligation imposed on any person by any rule of law . . . to disclose any matters to any other person shall not extend to requiring him to disclose a spent conviction or any circumstances ancillary to a spent conviction."

52. See the text to fn 73 *infra*.

53. See *Brotherton (No. 2)* [2003] Lloyd's Rep IR 746, [22].

54. *Ibid.*

55. *Economides v. Commercial Union* [1998] QB 587.

56. *March Cabaret Club v. London Assurance* [1975] 1 Lloyd's Rep 169, 177.

57. *Roselodge v. Castle* [1966] 2 Lloyd's Rep 113, 133, *per* McNair J.

58. [1978] 2 Lloyd's Rep 440, 460.

the surprising lack of experience among the experts of any actual disclosures by proposers of their previous convictions. I heard a large number of very prominent underwriters all of whom had spent many years in dealing with proposals for, in particular, fire insurance. Of these, Mr. Waller could speak of one case very recently when he was told that an inquiry was made by the National Association for the Care and Resettlement of Offenders about fire insurance of a London flat on behalf of a man who had been recently sentenced to three years for cheque and Post Office frauds. He also said he knew a colleague who had six cases of this kind and a broker who had had one, though he himself had no direct experience. Mr. Deyes had experience of one case where the husband of his assured was dismissed for suspected fraud and a previous conviction for fraud was discovered; but here the information came from an outside source and was not disclosed by the assured. None of the others could speak of any experience at all of disclosure of criminal offences.

In an important *dictum*, he continued:<sup>59</sup>

It seems strange, if insurance practice casts the net as wide as the defendants' witnesses would have me believe, that experience is so meagre, particularly in view of the very large number of crimes dishonestly committed every year and the almost universal adoption of some form of fire insurance for buildings.

This is pertinent to the use of expert evidence to establish materiality and is considered further below. Nevertheless, if true, the ideal of an established market practice being used to establish the response of the prudent insurer is absent. Indeed, when insurers have given evidence as to their response to an undisclosed allegation or conviction, judges have rejected their evidence as unconvincing.<sup>60</sup> What does this mean for the materiality of allegations? It suggests that judges are deciding the reaction of the prudent insurer on limited evidence, as comparator disclosures do not occur with sufficient regularity to establish a market norm. Moreover, it should not be forgotten that the "prudent underwriter" is not tied to market practice. It is the normative standard of what a prudent underwriter should do, and not merely an expression of what they currently do. As with the duty of care in negligence, the courts can set standards of behaviour and do not have to follow them.<sup>61</sup>

There are therefore substantial concerns as to the operation of materiality in respect of untrue allegations. That is not to say that the allegations in *The North Star* were not material, but that the basis for testing this was less rigorous than it ought to be. Further issues arise in the operation of the rule on insureds and insurers—the thorny question of reciprocity.

### 3. *Reciprocity: the insurer's duty of disclosure*

The notion of reciprocity as a basis for establishing the proper limits of non-disclosure in insurance contract law is not novel. Indeed, Bennett argues that this principle explains the materiality of unproven allegations: given that the insurer is not normally entitled to require an increase in the premium if the risk increases after contracting,<sup>62</sup> the insured

59. *Ibid.*

60. See the text to fn 86, *infra*.

61. See W Lucy, "Private Law: Between Visionaries and Bricoleurs", ch 8 of P Cane and J Gardner (eds), *Relating To Responsibility: Essays In Honor Of Tony Honoré* (2001).

62. At least, in the absence of any express contractual provision to the contrary.

should not be able to take advantage of any decrease in risk from that estimated at inception.<sup>63</sup> However, what is not then considered are the consequences for insurers facing allegations of misconduct.

The assumption that the moral hazard risk in insurance leads only to disclosures by prospective insureds is flawed. The role of the Financial Services Authority is to investigate failures by insurers and others to comply with statutory guidance. There is the clear possibility of allegations related to insurer conduct being investigated at the time of inception. On Bennett's analysis, an insured would be entitled to complain of material non-disclosure in those circumstances, even if the allegation proved to be unjustified. Slade LJ put the test for materiality for underwriter's disclosures in the following terms:<sup>64</sup> "the duty falling upon the insurer must at least extend to disclosing all facts known to him which are material either to the nature of the risk sought to be covered or the recoverability of a claim under the policy which a prudent insured would take into account in deciding whether or not to place the risk for which he seeks cover with that insurer."

This must be extended to cover the insurer's record in meeting market requirements where the contract is entered into for investment reasons. It is the functional equivalence of the insured's claims record. In practice, few insureds would pursue such a course of action, as the remedy is avoidance *ab initio*, only providing the return of the premium.<sup>65</sup> However, if insurance law is to remain wedded to its mirroring of the insured's duties as a justification for the refusal to extend the underwriter's obligations after contracting, then it must similarly impose extensive pre-contractual duties on the insurer.

Even a brief survey of the enforcement notices published by the Financial Services Authority<sup>66</sup> shows significant penalties being imposed on well-known insurers.<sup>67</sup> Many of these relate to the mis-selling of endowment policies, but others relate to wider issues such as the poor handling of complaints. Whilst such matters may not be material to the prudent insured when purchasing short-term and low value policies (such as holiday insurance), one might expect the hypothetical consumer to invest time and effort in considering where to invest in long term or high value products. If policyholders were fully informed, then they might rationally elect not to contract with companies under investigation even if no sanction were later imposed. This is the equivalent to establishing materiality by reference to the insurer's desire to know a proposer's claims record. The "no smoke without fire" point made most forcibly by Waller LJ in *The North Star*<sup>68</sup> would cut both ways. However, there does not appear to be any systematic disclosure to all potential insureds of such investigations.<sup>69</sup> Insurers casting the first stone by pressing for full disclosure of unproven rumours might do well to be aware of the glass houses in which they operate.

63. Bennett *The Law of Marine Insurance*, 2nd edn (2006), [4.82].

64. *La Banque Financière de la Cité SA (formerly named Banque Keyser Ullmann en Suisse SA) v. Westgate Insurance Co Ltd (formerly named Hodge General & Mercantile Insurance Co Ltd)* [1990] 1 QB 665 (CA), 772.

65. *Ibid.*

66. See <<[>>](http://www.fsa.gov.uk/Pages/Library/Communication/Notices/Final/).

67. In 2006 alone, Royal Liver Assurance faced a £550,000 penalty for mis-selling and Guardian Assurance £750,000 for poor handling of complaints linked to endowments.

68. [2006] EWCA 378, [17].

69. Issues might reach the public domain by disclosure to the stock market or the Financial Services Authority's website, but not in a systematic fashion. This raises the question as to when matters are not required to be disclosed because they are in the public domain.

### C. The timing of the assessment of materiality: the role of “hindsight”

On a related matter, we now examine the courts’ consideration of evidence that arose after placement of the risk: the use of “hindsight” evidence. It is assumed, for now, that the assessment of materiality is determined by reference to the situation at one fixed moment in time. That is, that the decision as to whether or not a circumstance needed to be disclosed will be based on evidence available at the moment that the right to avoid could first be unconditionally exercised, and later evidence could not change that result once made. This would be a consequence of the view of Mance LJ in *Brotherton (No. 2)*.<sup>70</sup> There, he stated: “It is clear that rescission in the general law of contract is by act of the innocent party operating independently of the court.”<sup>71</sup>

If correct, then materiality should be judged by reference to the facts known no later than the moment of contracting, as that is the earliest moment of potential avoidance. However, as will be seen in Part IV, this orthodox analysis of rescission as a self-help remedy is not uncontroversial.<sup>72</sup> Nevertheless, working on the assumption that Mance LJ is correct, we can consider the evidence the courts have utilized in forming their impressions of materiality to ascertain the “end point” for admissible evidence. This could be the moment of contracting, the moment that avoidance is first sought, the issue of the writ (or similar) or the moment of adjudication. If the evidence used in these cases only arose after contracting, then there is a conflict between theory and practice.

In *March Cabaret Club v. London Assurance*,<sup>73</sup> May J considered a defence of non-disclosure in respect of a charge of handling stolen goods. The insured was convicted of the offence after renewal of the policy. He decided not to challenge that result before the civil court.<sup>74</sup> The judge considered the case not on the basis of non-disclosure of the pending criminal proceedings, but of the insured’s guilt, which was not established at the time for disclosure. Indeed, the insured pleaded “not guilty” at his trial. His guilt was established after contracting but before the moment of avoidance.<sup>75</sup>

May J viewed the later conviction as crucial. As he put it: “there remained throughout . . . the duty to disclose all the material facts, one of them being the fact that *arrest, charge, committal or not*, he had in truth some nine months earlier committed the offence.”<sup>76</sup> The later conviction is therefore seen as resolving the uncertain state of affairs at the moment of contracting (an allegation combined with an innocent plea) in favour of an established “truth” of guilt. May J expressly rejected arguments based on the presumption of innocence and the rule against self-incrimination.<sup>77</sup>

No one has a right to a contract of insurance, and if a proposer has committed a criminal offence which is material and ought to be disclosed he must disclose it, despite the presumption of

70. This is how it was interpreted by Rix LJ in *Drake v. Provident* [2004] Lloyd’s Rep IR 277, [73]: “Nevertheless, there is in *Brotherton* repeated rejection of any element of hindsight in the analysis of materiality or inducement.”

71. [2003] Lloyd’s Rep IR 746, 758, [27].

72. See the criticism by Clarke (2003) 62 CLJ 556 and J O’Sullivan, “Rescission as a Self-Help Remedy: A Critical Analysis” (2000) 59 CLJ 509, considered *infra* in Part [IV].

73. [1975] 1 Lloyd’s Rep 169.

74. A conviction is *prima facie* evidence of guilt for a civil court. See Civil Evidence Act 1968, s 11.

75. By the letter of 19 April, 1971, considered by May J at [1975] 1 Lloyd’s Rep 169, 173.

76. *Ibid.*, 177 (emphasis added).

77. *Ibid.*

innocence, which is only a presumption, and despite the privilege of non-incrimination, which is only a privilege—or he must give up the idea of obtaining insurance at all.

What is crucial for the *North Star* situation is that May J's analysis is made with the benefit of hindsight. The "true" position (that of guilt) is established after contracting, but before the moment of avoidance, and is nevertheless used to determine that the insured's guilty mind ought to have been disclosed. It would therefore seem that it is (at the earliest) the moment of purported avoidance that operates as the time at which the "true" position is established.

The judgment of Forbes J in *Reynolds v. Phoenix Assurance*<sup>78</sup> is also of direct relevance. In 1971, the defendant had been accused of participating in a fraudulent conspiracy by the Colne Investment Corporation. The relevant insurance policy ran from 25 August 1973 for one year. This allegation was not disclosed to insurers but was not pursued until some five years later, when the police brought a prosecution. Reynolds was acquitted in March 1977, some nine months before the start of the insurance trial. Having been in dispute with his insurers over issues of quantum since the loss in 1973, the insurers amended their statement of defence to include the points on non-disclosure. It is not clear from the facts at what moment the insurers sought to avoid the contract,<sup>79</sup> but it appears to be after the time of the acquittal. If this is the case, then this is a close comparator to *The North Star*. We have a non-disclosed allegation of dishonesty, unsubstantiated at the placing of the risk, but later proved to be untrue. As noted above, Forbes J was clearly influenced by the later acquittal in finding the fact of the allegation to be immaterial. This forms part of the ratio of the case, unlike the contrary views expressed in *The Dora*, which are merely *obiter*.

In practice, this may simply mean that the use of hindsight evidence in these cases would no longer be tolerated. However, it does show the difficulty the judges have had to closing their eyes to what has subsequently happened, and dealing solely on the basis of hypothesis.

#### D. Materiality and the use of expert evidence

The use of expert evidence to establish materiality was considered in *Yorke v. Yorkshire Insurance*.<sup>80</sup> Medical evidence was adduced, in relation to the proposal for a life policy, as to the materiality of a number of different medical conditions. McCardie J recognized that the admissibility of this evidence raised issues of general importance. He noted that the approach of Lord Mansfield in *Carter v. Boehm* was not to use such evidence, but nevertheless argued: "the views of 150 years ago have been modified by the broader outlook of later judges and by a clear realization of the utility of expert testimony as an aid to the administration of justice."<sup>81</sup> His view was that this merely confirmed established practice.<sup>82</sup> Moreover, he was clear as to the dangers of rejecting such evidence: "if

78. [1978] 2 Lloyd's Rep 440.

79. This may have been at the moment at which the amended defence was issued, but the report is not clear.

80. [1918] 1 KB 662, 670.

81. *Ibid.*

82. He cited in support of this *Herring v. Janson* (1895) 1 Com Cas 177, *Scottish Shire Line v. London & Provincial Marine & General Ins Co* [1912] 3 KB 51, 70 and *Associated Oil Carriers v. Union Ins Soc of Canton* [1917] 2 QB 184.

excluded, it would deprive the Court of ascertaining those considerations and views which a tribunal may well require to know, and the insurance witness would by process of law be stricken with absolute silence on matters of importance to him.”<sup>83</sup>

McCardie J also confirmed that the range of admissible evidence extended beyond that from insurers and included, in the context of this case, that from medical experts.<sup>84</sup> In the case of allegations and convictions, evidence might properly be sought from representatives of the criminal justice system. This may be particularly relevant where the allegations are raised in a context or jurisdiction where the process from allegation to investigation to conviction differs markedly from the norm. To the extent that investigations undertaken by, eg, the Serious Fraud Office or the Greek authorities would not be routinely known to underwriters, this evidence should therefore be considered. This is consistent with the comments of Lord Lloyd of Berwick in *Pan Atlantic v. Pine Top*. In considering the likely response to the twin test of inducement and materiality he noted:<sup>85</sup>

The evidence of the insurer himself will normally be required to satisfy the court on the first question. The evidence of an independent broker or underwriter will normally be required to satisfy the court on the second question. This produces a uniform and workable solution, which has the further advantage, as I see it, of according with good commercial sense.

One significant argument against the use of such evidence relates to its quality. As noted above, judges have commented on the limited experience of underwriters of disclosed convictions. Moreover, the limits of materiality suggested in such evidence have often been rejected as unreasonable. In *Roselodge v. Castle*,<sup>86</sup> McNair J felt obliged to review the expert evidence given by Lloyd’s marine underwriters in the following terms:

Turning now to the evidence of Mr. Lindley and Mr. Archer as to the materiality of [the director’s] conviction 20 years before, it is true that both these witnesses stated in plain terms that they would not have written the risk had that fact been disclosed; but they were driven in cross-examination to state such extreme views that I am unable to accept their evidence on this point. It is not necessary to cite specific examples of their extreme views. But I would mention one. Mr. Archer stated that in his view a man who stole apples at the age of 17 and had lived a blameless life for 50 years is so much more likely to steal diamonds at the age of 67 that if he had told him this when putting forward a proposal at the age of 67, he would not have insured him. Many other instances of the like character can be cited from the transcript.

Similarly, Phillips J in *The Dora*<sup>87</sup> stated:

[The underwriter’s] evidence was to the effect that moral hazard was a most important consideration and that the offence of smuggling as much as a single bottle of whisky would be material. This evidence I found a little unrealistic.

In conclusion, there is evidence that insurers do not routinely face disclosed convictions and, when asked to speculate as to their likely reaction, tend to exaggerate the significance of the moral hazard. This must be controlled. Not only does it represent a potential

83. [1918] 1 KB 662, 670.

84. Citing *Lindenau v. Desborough* (1828) 8 B & C 587; 108 ER 1160.

85. [1995] 1 AC 501, 571G.

86. [1966] 2 Lloyd’s Rep 113, 132.

87. [1989] 1 Lloyd’s Rep 69, 93.

injustice to the insured in question, it may leave an entire class of (basically) honest potential insureds with little or no option but to conceal their convictions or go uninsured. The prudent insurer should behave as a rational economic actor, and that includes selling insurance at higher prices to those who are higher risk. Policymakers have chosen to regulate the irrational use of prejudicial material in underwriting decisions—this is the justification for statutory and soft-law controls on the use of spent convictions, race, sex, disability and genetic test results.<sup>88</sup> Similarly, if the courts have concerns that the market is not rational, then they must steer their own course.

### III. INDUCEMENT AND UNTRUE ALLEGATIONS

From what can be seen above, there is an established orthodox position that categorizes almost all allegations as material. It would be subject to review by the House of Lords, but would require the revision of established lines of authority. However, there is a less fraught route to reform. It must be questioned whether the insurer can establish inducement if the undisclosed allegation was, in fact, untrue. It is assumed that, following *Pan Atlantic v. Pine Top*,<sup>89</sup> the test for inducement in non-disclosure is equivalent to that for misrepresentation. This is not axiomatic, as the effect of an omission is not directly analogous to that of an action.<sup>90</sup> Nevertheless, a consideration of the authorities on misrepresentation is instructive. A previous edition of *Chitty* stated:<sup>91</sup>

It is essential if the misrepresentation is to have legal effect that it should have operated on the mind of the representee. It follows that if the misrepresentation did not affect the representee's mind, because he was unaware that it had been made, or because he was not influenced by it, or *because he would have entered into the contract even had he known the true facts*, or because he knew that it was false, he has no remedy.

It is this final sense of a lack of inducement that is critical. Assuming equivalence with non-disclosure, it appears that inducement is absent not only where the insurer would have contracted on the same basis had full disclosure been made, but also where the insurer would have contracted on the same basis *had the truth been known*. This may simply be a matter of semantics. However, if this represents the true position in law, then the insurer in *The North Star* would be denied a remedy even if the facts were material, because it was not induced. The question for the courts is therefore whether in testing for inducement in non-disclosure it has to consider the position in the event of full disclosure or the position if all facts were known, including those that would reduce the risk. This may present the House of Lords with a suitable mechanism for resolving the *North Star* conundrum. To declare the facts immaterial, or to create additional bars on the use of rescission, may require a determination to go well beyond the existing bounds of authority. However, the precise limits of inducement have not undergone the rigorous examination that materiality

88. See J Davey, "Future Imperfect: Human Genetics and Insurance" [2000] JBL 587.

89. [1995] 1 AC 501, 544E–F, *per* Lord Mustill.

90. See M Hemsworth, "Inducement in Insurance Law: Sins of Commission and Sins of Omission" (1999) 58 C LJ 59.

91. A Guest (ed), *Chitty on Contracts*, 27th edn (1994), [6–019] (emphasis added, citations omitted). The section has been rewritten in the current edition, under the editorship of Hugh Beale; 29th edn (2004), [6–031].



faced in *Pan Atlantic*.<sup>92</sup> Moreover, it is not present in the marine insurance statutes. This provides the courts with a less fraught route to achieve the same result. Some support for this approach derives from Lord Mustill's description of the purpose of the inducement rule: to ensure a proportional remedy by linking the remedy to harm caused. It was not to ensure an "accurate presentation of the risk" (or any similar term) but to ensure a proper causal link. As Lord Mustill noted in justifying the imposition of the requirement of inducement, "to enable an underwriter to escape liability when he has suffered no harm would be positively unjust, and contrary to the spirit of mutual good faith".<sup>93</sup>

The major obstacle to such a path is the interpretation given by Hemsworth to the *obiter* comments of Lord Lloyd in *Pan Atlantic*.<sup>94</sup> She read his analysis as follows: "he expressed inducement in terms that, had the material fact been communicated to the actual insurer, that insurer would have refused to take the risk or would have required a higher premium."<sup>95</sup> However, properly read, Lord Lloyd does not seem to rule out the narrower conception of inducement proposed in *Chitty*.<sup>96</sup> Indeed, it is suggested that this precise meaning of inducement was not considered in detail in *Pan Atlantic*.

What of the higher courts since *Pan Atlantic*? In *Drake Insurance v. Provident Insurance*,<sup>97</sup> Rix and Clarke LJ were prepared to go behind the non-disclosure to consider what the reaction of the actual insurer would have been if disclosure had been made. A similar approach is found in the Court of Appeal in *The North Star*. What is crucial is that they see disclosure as a reactive process, whereby the true position (that the accident in question was a no-fault accident) would have been discovered following discussion between the parties. This does not go as far as the *Chitty* position (which compares the effects of misrepresentation with the true position) but recognizes that the truth may come out. With unjustified allegations of criminality, this does not get us much further, as insurers are unlikely to take the insured's word that he is innocent. However, as the burden of proof falls on the underwriter, it will need to establish that the true position would not have been established by further negotiation.

#### IV. RESCISSION, SELF-HELP AND THE DOCTRINE OF UTMOST GOOD FAITH

On the established orthodox view, if the underwriter gains the right to avoid the contract by operation of the Marine Insurance Act 1906, s 18,<sup>98</sup> it is not lost merely because the insurer becomes aware that the allegation was in fact untrue. However, this orthodox view is open to question. Bars on the use of the right to avoid *ab initio* could be derived from two distinct sources: first, the equitable and common law rules on avoidance; and,

92. See H Bennett, "Utmost Good faith, Materiality and Inducement" (1996) 112 LQR 405, 407.

93. [1995] 1 AC 501, 549C-D.

94. She refers to the discussion at *ibid*, 568a-569e and 571f.

95. (1999) 58 CLJ 59, 61.

96. Lord Lloyd stated the test as "Did the misrepresentation or non-disclosure induce the actual insurer to enter into the contract on those terms?": [1995] 1 AC 501, 571F.

97. [2004] Lloyd's Rep IR 277, [62-65], *per* Rix LJ, and [131]-[137], *per* Clarke LJ

98. Alternatively, by operation of the equivalent common law rule in *Pan Atlantic Ins v. Pine Top Ins* [1995] 1 AC 501.

secondly, the doctrine of utmost good faith, in its post-contractual phase. These are considered below.

### A. Rescission as a “self-help” remedy in general contract law

The recent Court of Appeal decision in *Brotherton (No. 2)* assumes that the right to avoid an agreement in general contract law is not affected by subsequent events.<sup>99</sup> Malcolm Clarke, among others, has his doubts. Writing in the *Cambridge Law Journal*,<sup>100</sup> he attacked the *Brotherton* analysis as having overlooked a significant alternative line of authority:

[Mance LJ] referred to two (non-insurance) cases, *Abram Steamship Co v. Westville Shipping Co*<sup>101</sup> and *Horsler v. Zorro*,<sup>102</sup> which were mainly concerned with issues such as restitution . . . [N]either is authority for more than this, that, when justified, rescission is the act of the party and does not require a court order. Compare, however, some important judicial statements, to which the Court of Appeal does not seem to have been referred. In a case of rescission the court has power to “do what is practically just”: Lord Blackburn in *Erlanger v. New Sombbrero Phosphate Co*.<sup>103</sup> The remedy “is equitable. Its application is discretionary”: Lord Wright in *Spence v. Crawford*.<sup>104</sup> Both statements were approved in *Vadasz v. Pioneer Concrete*,<sup>105</sup> in which the High Court of Australia concluded that the doctrine of unconscionability (better established in Australia than in England) enables the court “to prevent one party obtaining an unwarranted benefit at the expense of the other”.

O’Sullivan develops the critique, having initially identified the two fundamental assumptions at the heart of the *Brotherton* analysis:<sup>106</sup>

The self help analysis of rescission involves two related notions. First, that the innocent party can rescind purely by his own act of election, by giving notice to the other party: there is no formal legal requirement or need to obtain a court order, even though in practice this may be necessary. Secondly, that where judicial rescission is obtained, it is nonetheless still the plaintiff’s election which is regarded as the operative rescinding event, so the judicial relief is “backdated” to the date of that election, in theory rendering vulnerable dealings with the subject matter of the transaction between election and court order.

In seeking support for these propositions, O’Sullivan reviewed the leading texts. She discovered a complete absence of consensus as to whether rescission is sometimes or always a “self-help” remedy. The dispute appears to be between those who regard its nature as fixed, and those who regard it as dependant on the underlying vitiating factor. This survey encompassed authors of the stature of Roy Goode, Peter Birks, Jack Beatson, Andrew Burrows and John (JC) Smith. Moreover, there is a similar lack of coherence amongst the case law. Whilst “self-help” seems to be a settled characteristic of fraudulent misrepresentation, it has been applied, albeit erratically, to innocent misrepresentation.<sup>107</sup>

99. [2003] Lloyd’s Rep IR 746, [23].

100. M Clarke, “Refusing Rescission: Contracts of the Utmost Bad Faith” (2003) 62 CLJ 556, 558.

101. [1923] AC 773.

102. [1975] 1 Ch 302.

103. (1878) LR 3 App Cas 1218, 1279.

104. [1939] 3 All ER 271, 288.

105. (1995) 184 CLR 102, 114.

106. J O’Sullivan, “Rescission as a Self-Help Remedy: A Critical Analysis” (2000) 59 CLJ 509, 511–512 (citations omitted).

107. *Ibid.*, 515.

O'Sullivan charts this confusion to the imprecise language in the House of Lords in *Abram Steamship Co v. Westville Shipping Co*<sup>108</sup> and other cases. The blurring of the concepts of misrepresentation and fraud, and of termination for breach and rescission, at a time at which the Judicature Acts were merging the systems of law and equity have left a series of conflicting *dicta* in this area. This, in turn, has led to selective analysis by textbook authors and judges.

Unlike Clarke's, O'Sullivan's focus is not on insurance contract law, but she relies on *Ionides v. Pender*<sup>109</sup> to place "certain instances of non-disclosure" as common law rescission, and therefore more likely to be operated on a self-help basis.<sup>110</sup> Of course, insurance law makes no distinction between innocent, negligent and fraudulent non-disclosures, and so it is not axiomatic that the rule for fraudulent misrepresentations should be applied. Given the more recent statement in *Brotherton (No. 2)*<sup>111</sup> that the remedy, at least in those cases, is equitable in origin, this would appear to take it outside the *Abram Steamship* line of authority, as Clarke suggested. Despite this, there are clear statements in *Brotherton (No. 2)* and *Drake v. Provident* that the remedy is operative from the moment of election by the insurer.<sup>112</sup>

Proper consideration of these issues is a matter for the House of Lords, given its potential impact on contract law generally. However, the failure in *The North Star* to establish the insurer's knowledge (whether actual or constructive) of the acquittals during the trial may be crucial. Nevertheless, there is a model for the House of Lords accepting jurisdiction to review the operation of self-help remedies. Where one party has committed a repudiatory breach, it is established that the innocent party has an election: whether to terminate or affirm the contract. This is a "self-help" remedy and does not need a court order to confirm the decision. However, in *White & Carter (Councils) v. McGregor*,<sup>113</sup> Lord Reid recognized the general supervisory role of the courts over the exercise of contractual rights:

It may well be that, if it can be shown that a person has no legitimate interest, financial or otherwise, in performing the contract rather than claiming damages, he ought not to be allowed to saddle the other party with an additional burden with no benefit to himself. If a party has no interest to enforce a stipulation, he cannot in general enforce it: so it might be said that, if a party has no interest to insist on a particular remedy, he ought not to be allowed to insist on it.

This does not, in itself, go far enough to deprive the insurer of the right to avoid *ab initio*. The insurer is not wishing to waste resources by performing—quite the opposite. However, to say that all "self-help" remedies are not subject to later review is incorrect, and an extension of the *White & Carter* principle is not inconceivable. However, it is recognized that the same development of a wide-ranging notion of unconscionability led the High Court of Australia to grant a cause of action for promissory estoppel in *Walton Stores v. Maher*.<sup>114</sup> Given the unfavourable reaction of many British commentators,<sup>115</sup> and

108. See *supra*, fn 101.

109. (1874) LR 9 QB 53.

110. (2000) 59 CLJ 509, 517 fn 42.

111. [2003] Lloyd's Rep IR 746, [34].

112. *Brotherton (No. 2)* [2003] Lloyd's Rep IR 746, [34]; *Drake v. Provident* [2004] Lloyd's Rep IR 277, [69].

113. [1962] AC 413, 431.

114. (1988) 164 CLR 387.

115. Eg. R Halson, "The offensive limits of promissory estoppel" [1999] LMCLQ 256.

the sceptical approach of the Law Lord with the most experience in insurance law,<sup>116</sup> it is difficult to see English law following this line of reasoning presently.

### **B. The bilateral and continuing nature of utmost good faith**

There is a clear division between Lord Mance and the remaining insurance judges in the Court of Appeal as to the future direction of insurance contract law. With Lord Mance unable to hear the case unless it reaches the House of Lords, *The North Star* was a missed opportunity to establish a precedent in favour of a good faith limit on the insurer's right to avoid for non-disclosure. The potential conflict with *Brotherton (No. 2)* deserves clarification. That case was concerned with circumstances that remained unresolved up to the moment of litigation. In rejecting the call for a trial on the truth of these issues Mance LJ stressed the potential cost implications for insurers.<sup>117</sup> However, he stated that he was not establishing a rule for cases where the facts were established prior to avoidance,<sup>118</sup> and this interpretation was confirmed by Rix LJ in *Drake v. Provident*.<sup>119</sup> This is the situation in *The North Star*. Here, the falsity of the allegations was established prior to avoidance, making this a much better claim for characterization as a "bad faith" use of utmost good faith rights, although the insurer's knowledge at the moment of avoidance was not examined at first instance.<sup>120</sup> Moreover, Mance LJ's concern as to exorbitant costs is diminished, as insurers would only have to consider the new evidence, and not discover it. This is consistent with Rix LJ, who noted:<sup>121</sup>

the decision whether or not there is a right to avoid is not a decision that has to be made in speed as a matter of instant business: it is a decision made after the event in the light of new facts (the discovery of a non-disclosure) which have to be considered for their legal effect.

The insurer's right to challenge an acquittal, and the subsequent costs, are the same whether evidence arises before or after placing the risk. As regards the costs issue, the facts of *The North Star* are therefore much closer to *Drake v. Provident* than *Brotherton*, and ought to have been viewed as a logical extension of that decision.

Rix LJ gave a fully reasoned preview of his approach in *Drake v. Provident*.<sup>122</sup> His initial comments demonstrate a degree of sympathy with the concept that insurers might face restrictions on their right to avoid for non-disclosure. Citing extensively from Lord Hobhouse in *The Star Sea*,<sup>123</sup> he opined that "it would be consonant with these views that the doctrine of good faith should be capable of limiting the insurer's right to avoid in circumstances where that remedy, which has been described in recent years as draconian, would operate unfairly".<sup>124</sup>

116. In *Brotherton (No. 2)* [2003] Lloyd's Rep IR 746, [29], Mance LJ (as he then was) doubted the validity of limits on the self-help nature of avoidance: "neither principle nor sound policy supports such a conclusion."

117. [2003] Lloyd's Rep IR 746, [30]

118. *Ibid.*, [28].

119. [2004] Lloyd's Rep IR 477, [73].

120. This failure to establish the insurer's knowledge at avoidance is hardly surprising; on the law as it stands, it is irrelevant.

121. *Ibid.*

122. *Ibid.*, [79]–[93].

123. *Manifest Shipping Co Ltd v. Uni-Polaris Ins Co Ltd (The Star Sea)* [2003] 1 AC 469.

124. [2004] Lloyd's Rep IR 277, [87].

He saw this as part of a growing judicial trend towards the amelioration of the harshness of insurance contract law.<sup>125</sup> This view, however, reaches a crucial obstacle. How is it that the insurer can be acting contrary to the doctrine of good faith by exercising rights gained under that same doctrine? On this analysis, restrictions based on the doctrine of good faith would be more readily awarded if the right to be controlled arose outside that doctrine—eg, for breach of an insurance warranty—than if the right is itself derived from good faith. There is otherwise a potential inconsistency in the doctrine of utmost good faith giving rights with one hand and taking them away with the other.<sup>126</sup>

This leads back to the start, and materiality and inducement. On Rix LJ's analysis, if circumstances could arise whereby an insurer would be able to avoid for non-disclosure, despite a lack of good faith, then the doctrine of good faith should not give them that right in the first place. He contended:<sup>127</sup>

If it is right to allow that circumstances could arise where an insurer would not be in good faith by acting on a *prima facie* right to avoid for non-disclosure, then the question would have to be faced as to the conceptual analysis whereby an exercise of a right to avoid could be invalidated by the insurer's bad faith. This is not an easy question. It is evaded if the insurer's bad faith is used to render a non-disclosure immaterial in the first place: because in that case no right to avoid ever arises.

One could add to this the contention that it is not only the notion of materiality that could act to police bad faith avoidances. As noted above, a thoughtful development of the doctrine of inducement in non-disclosure could reach the same result. Where the contract made is the same as would have been made had the insurer known the truth, then it should not be treated as having been induced.

Before leaving this section, it is worth noting the lack of an effective sanction for insurers who wrongfully avoid the policy.<sup>128</sup> If we are to limit insurers' rights to avoid, we should consider the consequences of wrongful avoidance. This would be limited to circumstances where the underwriter sought to avoid when in fact it did not have the right to do so, and this would not simply be where the allegation were untrue, but where the insurer had actual or constructive knowledge of this at the moment of avoidance. Following the (questionable) assertion that the insurer's obligation is to prevent the loss, and not to pay damages, consequential harm is not recoverable for late or non-payment of an insurance claim. Moreover, there is no implied obligation on the insurer to handle claims in a timely fashion.<sup>129</sup> On this basis, if the law puts the risk of unknown circumstances becoming known on the insurer, then it will not face any substantial penalty for its wrongful avoidance.<sup>130</sup> By contrast, the effective penalty to the insured where it bears the risk is considerable: loss of cover retrospectively after a casualty has already been suffered.

125. *Ibid.* For further statements to this effect, see Mance LJ in *Friends Provident v. Sirius International* [2005] 2 Lloyd's Rep 517.

126. [2004] Lloyd's Rep IR 277, [88].

127. *Ibid.*, [93].

128. See J Lowry & P Rawlings, "Insurers, Claims & the Boundaries of Good Faith" (2005) 68 MLR 82.

129. See C Ying, "Damages for late payment of insurance claims" (2006) 122 LQR 205.

130. See, however, the discussion of licence fee damages in J Davey, "Once More Unto the Breach: Remedies for the Late Payment of Insurance Claims after *Blake*", in P Giliker (ed), *Comparative Perspectives on Contract and Unjust Enrichment* (Martinus Nijhoff, forthcoming).

## V. CONCLUSION

The interweaving of materiality, inducement and rescission; the extensive policy concerns and the considerable authority already present in this area make this an area of law more suited to the supervisory role of the House of Lords rather than the Court of Appeal. It is to be hoped for the sake of legal principle that leave is granted. However, it is unlikely to alter the result in *The North Star*, as the insurer's knowledge (or otherwise) of the acquittals at the time of avoidance was not established at first instance. What is clear is that the current legal position fails to deal appropriately with an identifiable class of circumstances. To defend the rule on the grounds of certainty of result is unconvincing: we could have an equally clear rule that nothing need be disclosed.<sup>131</sup> The difficulty is how to remedy the mischief. Given the House of Lords' decisions in *The Star Sea*<sup>132</sup> and *Pan Atlantic v. Pine Top*,<sup>133</sup> changes to the nature of materiality and the post-contractual duties of good faith are unlikely. However, a shift in the precise limits of the test for inducement could give full force to its intended role: as a limiting factor ensuring that the remedy of avoidance is only granted where the insurer is genuinely disadvantaged by the non-disclosure. Otherwise, the law risks falling into disrepute. As noted above, insurers giving evidence are not uniformly trusted by the judges to make rational responses to allegations of criminality. The law must require them to act rationally in response to disclosures or otherwise to bargain for special treatment. Like financiers, they can ask questions and rely on the doctrine of misrepresentation to regulate misleading statements. Insurers should be entitled to a fair presentation of the risk, but no more. Too often insurers have claimed, and been given, special treatment under the doctrine of utmost good faith. They must either accept the application of a functionally equivalent standard to limit their own behaviour, or face the reduction of those privileges.

131. *Cf* Gay [2004] LMCLQ 1, 8.

132. [2003] 1 AC 469.

133. [1995] 1 AC 501.