

CHAPTER 3

The insurer's duty of good faith – is the path now clear for the introduction of new remedies?

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3.1 Introduction

It has long been established that in insurance law the duty of good faith is reciprocal¹ and the insurer is expected to act in good faith in his dealings with the assured in the same fashion as the assured is expected to observe good faith towards the insurer. The insurer's duty of good faith has been traditionally traced to s. 17 of the Marine Insurance Act (MIA) 1906² which stipulates in a general manner that: "A contract of marine insurance is a contract based upon the utmost good faith, and, if the utmost good faith be not observed by either party, the contract may be avoided by the other party."

The fact that the only remedy afforded by this section is "avoidance" of the contract creates enormous difficulties. At the pre-contractual stage, in most instances "avoidance" would be an impractical remedy for the assured, especially if a breach is detected after the insured property suffers a loss. The duty at the post-contractual stage is also not free from controversy. In this context, the remedy of "avoidance" is often deemed to be too harsh³ and courts have been forced to resort to innovative construction techniques in order to impose restrictions on the scope of the post-contractual duty of good faith. Initially, on the premise that there is no justification for requiring the same high degree of openness post-contractually as is expected from parties at the pre-contractual stage, it was held in *The Star Sea* that only fraudulent failure to act in good faith, post-contract, gives rise to the right to avoid. Building upon that principle, in *K/S Merc-Skandia XXXII v Certain Lloyd's Underwriters (The Mercandian Continent)*,⁴ Longmore LJ held that it would be appropriate to invoke the remedy of avoidance in a post-contractual context if the innocent party would otherwise be justified in accepting the conduct of the

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1 Lord Mansfield in *Carter v Boehm* (1766) 3 Burr 1905, famously said: "The policy would equally be void, against the underwriter if he concealed; as, if he insured a ship on her voyage, which he privately knew to be arrived, and an action would lie to recover the premium."

2 Especially given that ss. 18–20 of the MIA 1906 devote their attention to specific pre-contractual duties of the assured and his intermediaries, the only provision in the Act that the insurer's duty could derive from is s. 17 of the MIA 1906.

3 This led Lord Clyde in *Manifest Shipping Co Ltd v Uni-Polaris Shipping Co Ltd (The Star Sea)* [2001] UKHL 1; [2003] 1 AC 469, at [6], to comment that limiting the scope of s. 17 to pre-contractual negotiations "appears to be past praying for".

4 [2001] EWCA Civ 1275; [2001] 2 Lloyd's Rep 563.

party in breach of the duty as a repudiatory breach of the policy. This approach presupposes that the need to observe good faith in the post-contractual context would normally be associated with a contractual obligation, and it attempts to align “avoidance” with contractual remedies that would be applicable when the clause in question is breached in a fraudulent fashion. Naturally, these authorities, originally designed to ameliorate the harshness of the remedy of avoidance, impose a serious constraint on the scope of the insurer’s post-contractual duty of good faith, if not trivialising it.

One of the fundamental changes imposed by the Insurance Act 2015 (“the 2015 Act”) is removal of the remedy of “avoidance” from the scope of s. 17.⁵ In its new format, this section does nothing more than stipulate that “a contract of marine insurance is a contract based upon the utmost good faith.” This was a necessary step to ensure that other reforms introduced by the 2015 Act, especially new proportionate remedies available to an insurer in case of breach of the assured’s duty of fair presentation of the risk⁶ and remedies afforded to the insurer in case of submission of a fraudulent claim,⁷ are not undermined by the continued existence of reference to the remedy of “avoidance” in s. 17.

Evidently, the driving force behind the alteration to s. 17 of the MIA 1906 was the desire to tidy up insurer’s remedies in cases of pre- or post-contractual breach of the good faith duty on the part of the assured. However, it is possible that the change in the relevant statutory provision might also have an impact on the position of the insurer, accelerating the organic development of the doctrine by the courts, given that the unpopular remedy associated with this section is out of the way. The objective of this paper is, therefore, to evaluate and comment on the future development of the insurer’s duty of good faith by taking into account relevant authorities decided prior to the 2015 Act coming into force, and general principles of law. Although the amended version of s. 17 in itself is not intended to give an insurer a cause of action,⁸ it is submitted that reaffirmation of the underlying nature of insurance contracts as requiring utmost good faith can still play a vital role in the development of the insurer’s duty of good faith by directing the attention of the courts to the common law position as it stood prior to the passing of the MIA 1906.

3.2 Pre-contractual duty of good faith of the insurer

At the outset, it needs to be stressed that, even before the introduction of the 2015 Act, the assured has always been in a strong position in a case where he is induced to enter into an insurance contract following a material misrepresentation on the part of the insurer at the formation stage. It is open to the assured in such an instance to rely on alternative courses of action. For instance, a fraudulent

⁵ See s. 14(3)(a) of the Insurance Act 2015.

⁶ See s. 8 and Schedule 1 of the Insurance Act 2015.

⁷ See s. 12 of the Insurance Act 2015.

⁸ See “Insurance Contract Law: Business Insured’s Duty of Disclosure and the Law of Warranties”, Joint Consultation Paper, (2012), LCCP 204/SLCDP 155 at p. 127.

misrepresentation made by the insurer to induce the latter to enter into the contract is likely to satisfy ingredients of the tort of deceit in line with the judgment of *Derry v Peek*.⁹ When it comes to the measure of damages for the tort of deceit, the assured will be entitled to an award which would put him in the same position he would have been in had the tort been never committed. This would, therefore, enable the assured who enters into an insurance contract as a result of the fraudulent misrepresentation of the insurer and finds out later that the policy has no practical use for him, to recover the cost of repair or cost of reinstatement in cases where the subject matter suffers a loss, on the premise that he has been deprived of the anticipated benefits from pursuing an alternative cause of action (e.g. purchasing another insurance policy).¹⁰ Furthermore, the Misrepresentation Act (MA) 1967 provides an opportunity to the assured to sustain a claim for damages even in cases where the misrepresentation is merely negligent. The MA 1967 allows the assured to recover damages in the same measure as if he were suing for the tort of deceit,¹¹ so the measure of damages will be calculated favourably from the assured's perspective. Therefore, it is fair to say that revamping of s. 17 is unlikely to alter the current state of play in a case where the insurer fraudulently or negligently makes a misrepresentation as to the nature of the cover; although, admittedly, in practice instances of this nature are rather rare.

However, is the insurer under a duty to speak at the formation stage and, if so, could his silence on certain occasions be treated as a breach of his good faith obligation? For example, if the insurer is in possession of information relating to the assured's entitlement under the policy or sells an insurance product which he knows is unlikely to benefit the assured for a variety of reasons, would the insurer be in breach of the pre-contractual duty of good faith by opting to keep silent? And, more significantly, what remedy would be available to an assured in such an instance?

This was the central issue in *Banque Financière de la Cité v Westgate Insurance Co Ltd*.¹² Relevant facts of this rather complex case can be summarised in the following manner. A fraudster named Ballestero persuaded a consortium of Swiss banks to make loans of 26.25 million Swiss francs to four companies controlled by him. The primary security for the loan was a parcel of gemstones independently valued at 95 million Swiss francs. In fact, the parcel of gemstones later proved to be worthless. As secondary security, a credit insurance policy for 37 million Swiss francs was put forward which was specifically written to cover default by Ballestero's companies for the eventuality of the gemstones proving to be inadequate security. The banks instructed an insurance broker to arrange the credit insurance policy. The task of securing the policy was delegated to one of the employees of the broker's firm, Mr Lee. In the process of setting up the credit policies with various insurers, Mr Lee engaged in several fraudulent activities. In particular, he

9 (1889) 14 App Cas 337.

10 *Dadourian Group International v Simms* [2006] EWHC 2973 (Ch); [2006] ALL ER 351.

11 See *Royscot Trust Ltd v Rogerson* [1991] 2 QB 297 (CA).

12 [1990] 1 QB 665; [1987] Lloyd's Rep 69; [1990] 1 QB 665 (CA); [1991] 2 AC 249 (HL) (sub nom *Banque Keyser Ullman SA v Skandia (UK) Insurance Co Ltd*).

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issued cover notes on behalf of some of the insurers undertaking second and third layers of the insurance several months prior to these policies being, in fact, obtained. By June 1980, the full amount of insurance had been obtained. In May 1980, however, an employee of one of the underwriters providing cover for the primary level became aware of Mr Lee's fraud but did not report this to the banks. Under the assumption that the loans were firmly secured, the banks continued making advances up to 80 million Swiss francs to the companies of Ballestero between August 1980 and March 1981. Mr Lee was asked to extend the current layers of credit insurance and arrange a fourth layer. The fourth layer had never been arranged; although continuing with his earlier practice, Mr Lee issued a cover note in respect of the new layer for the banks. Before Mr Lee's wrongdoings were discovered, the extent of the fraud perpetrated by Ballestero became apparent to the banks when his companies defaulted on repayment of the loans. In 1983, the banks brought actions against the insurance brokers and Mr Lee for negligence and fraud, respectively. The claim was settled by the insurance brokers to the extent of their liability insurance. When the banks turned to the credit insurers, to the extent that such policies were in place, the underwriters refused payment on the ground of Ballestero's fraud by virtue of a clause that appeared in the credit policies:

The insurers shall not be liable hereunder for . . . any claim or claims arising directly or indirectly out of or caused directly or indirectly by fraud attempted fraud misdescription or deception by any person, firm or, company.

Running out of options, the banks then turned to the insurers on the premise that the insurers failed to inform them of other frauds committed by Mr Lee of which the insurers were aware. It was contended that, had there been full disclosure, the banks would have gone elsewhere for the additional insurance and would not have used the relevant brokerage firm and, particularly, Mr Lee. The damages sought from the insurers represented the advances made between August 1980 and March 1981.

The first instance judge and the Court of Appeal were receptive to the idea that the insurer is expected to disclose certain facts and circumstances to the assured at the pre-contractual stage. The source of this duty was traced to s. 17 of the MIA 1906; but given that this provision is silent as to the scope of such a duty, it was necessary to engage in a painstaking analysis of the scope of the insurer's duty of disclosure at the pre-contractual stage. In particular, the opinions expressed by the Court of Appeal can be viewed as providing insightful guidance on the matter. The first issue that needed to be settled was the nature of the materiality test in this context. On that matter, the first instance judge, Steyn J, took a very liberal stand. He was disposed to accept that the duty of the insurer at the pre-contractual stage should be viewed as an example of his general duty of "good faith and fair dealing" and accordingly the insurer should be expected to disclose every circumstance and fact which, if not disclosed, would influence the assessment process of the assured whether to conclude the contract of insurance or not.¹³

¹³ See [1987] 1 Lloyd's Rep 69, at 95.

Applying this test, Steyn J, reached the conclusion that the leading underwriter was in breach of his pre-contractual disclosure obligation by not revealing the fraud of Mr Lee, because Mr Lee was a key figure in setting up the second and third layers of the cover and the banks relied on him heavily for their information concerning the transactions.¹⁴

The fundamental problem in Steyn J's analysis is the fact that the scope of materiality is so far-reaching that, if adopted, good faith and fair dealing would possibly require the insurers not only to disclose circumstances pertinent to the nature of the risk but also to provide advice as to the terms of the contract that the assured is about to enter, or even guidance as to the state of the market on a particular product. Naturally, these are the duties that one would expect an independent agent (that is, a broker) to perform at the formation stage, but perhaps not an insurer. Also, defining "materiality" in this fashion would put the concept out of line with its counterpart that applies to the assured at the pre-contractual stage. In that context, the disclosure duty would not require the assured to give guidance to the insurer as to the nature of their business or the state of the market.¹⁵ Pleasingly, the Court of Appeal has taken a more sober stand on the matter. Whilst concurring with Steyn J, that there had been a breach by the insurers of the duty of disclosure, the Court of Appeal has subscribed to a rather different and more precise materiality test. In the Court of Appeal's view, the insurer is expected to disclose at the pre-contractual stage all facts known to the insurer as long as such facts relate 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."¹⁶ Tying the materiality requirement to factors that are relevant to the decision-making process of the assured, such as attributes of the risk and recoverability under the policy, the Court of Appeal has marked its boundaries in a clearer fashion compared to Steyn J's test.¹⁷ Under this test, it is likely that the insurer

¹⁴ A desire to find a suitable remedy in all circumstances (*ubi jus ubi remedium*) was the driving force behind the judgment of Steyn J. His ruling seems to have been based on his appreciation of "justice and policy considerations". See particularly, [1990] 1 QB 665, at 706.

¹⁵ Courts have repeatedly held that the disclosure duty of the insurers at the pre-contractual stage is not extended to giving advice as to the state of the insurance market, in particular the losses facing the insurers on a particular type of product. Rix J, in *Norwich Union Life Insurance Society v Qureshi* [1999] Lloyd's Rep IR 263, at 272, expressed the view that the imposition of a duty of good disclosure on insurers in relation to the investments to be made by the assured would convert them into financial advisers. The Court of Appeal decided in similar fashion in joint cases *Aldrich v Norwich Union Life* and *Norwich Union Life v Qureshi* [2000] Lloyd's Rep IR 1.

¹⁶ [1990] 1 QB 665, at 772.

¹⁷ It should be stressed that the Court of Appeal's approach to materiality found considerable support at the House of Lords even though it was not necessary to apply it to solve the case. Lord Templeman [1991] 2 AC 249, at 280, who gave the only substantial speech in the House, described the reasons given by the Court as "cogent". The House of Lords, viewing the matter in a different light, came to the conclusion that the case could be disposed of without considering whether the insurer was under a duty to disclose Mr Lee's fraud by reason of the obligations of an insurer to deal with the proposer of the insurance with the utmost good faith. Their Lordships found in favour of the insurers by employing a straightforward causation analysis. It was held that the losses suffered by the banks did not stem from the fraudulent activities of Mr Lee carried forward by the brokerage firm's failure to inform them. Mr Lee's fraud did not cause a claim under the policy to arise. It was the fraud

will be expected to disclose: the existence of fraud in connection with the risk undertaken; any defence which he is aware of and may rely on at a later stage;¹⁸ information in relation to the state of the subject-matter insured that the insurer is privy to;¹⁹ and even foreign illegality²⁰ or any proposed change in law that might have an impact on recovery under the policy.²¹ The decision of the Court of Appeal, however, still left a sour taste in the mouths of the banks despite the victory on the point of materiality, as they failed in their quest to recover damages for the insurer's breach of good faith. The Court of Appeal took the stand that the relevant provisions of the MIA 1906 do not give rise to damages and it proved impossible to establish any other alternative cause of action (i.e. tort) for damages.

A number of observations as to the nature and scope of insurer's duty of good faith in the light of *Banque Financière* litigation are in order. First, it is indisputable that such a duty exists and s. 17 of the MIA 1906 has been viewed as the statutory basis for codifying the principles of equity law developed over the centuries prior to the enactment of the MIA 1906. Second, the first instance judge and the Court of Appeal, by drawing an analogy with the assured's pre-contractual duty of good faith, needed to engage in judicial law making in order to define the degree of materiality required in this context, given that s. 17 is silent on the point. Last but not least, "avoidance" not only provides an impractical remedy for the assured but also has proved something of a stumbling block in allowing alternative remedies (notably damages), as its existence led the judges in the Court of Appeal to conclude that the judicial basis of the statutory duty stems from the jurisdiction exercised by the Court of Equity.²²

It is submitted that removal of the remedy of "avoidance" from the equation presents a great opportunity to courts to develop the insurer's pre-contractual duty of good faith in a not organic but systematic fashion in the years to come. Although the 2015 Act is silent on the insurer's duty of good faith, it is plausible to suggest that s. 17, which stipulates that an insurance contract, unlike other types of contracts, is a contract based on utmost good faith, could be of use in asserting that a duty, comparable with the pre-contractual duty of good faith of the assured, should be imposed requiring the insurer to act in a fair fashion to the assured when assessing the risk proposed to him. Here, it is not proposed that s. 17 should be viewed as the source of the insurer's duty of good faith. The duty should be

of the borrower, Ballestero, which caused the loss under the policy in the present case; but of course that kind of loss was excluded from the policy by express provision of the contract anyway.

18 This would have been the case in *Banque Financière de la Cité v Westgate Insurance Co Ltd* if the insurer had been aware of the fact that Ballestero was a fraudster, which would invalidate any claim made under the credit insurance policy due to the existence of the exclusion clause in the contract.

19 *Carter v Boehm* (1766) 3 Burr 1905.

20 An example would be where the kidnap and ransom insurer providing cover for a ship registered in a foreign country fails to disclose to the assured that payment of ransom would be illegal under the law of that state.

21 For a similar situation, see *Duffell v Wilson* (1808) 1 Camp 401.

22 See, in particular, the judgment of Slade LJ [1990] 1 QB 665, at 780. This stance seems to have been endorsed by the House of Lords [1991] 2 AC 249, at 280, per Lord Templeman. The parties in *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd (The Star Sea)* [2001] UKHL 1; [2003] 1 AC 469 were prepared to proceed on the premise that good faith duties do not attract damages as a remedy.

traced back to the common law, and s. 17 in its amended format could be viewed as a stepping stone, offering a reminder of the common law position laid down by Lord Mansfield around 250 years ago to the effect that the duty of good faith is reciprocal in character.

At this juncture, one might rightly indicate that the decision in *Banque Financière* could stop such an assertion in its tracks. The author, however, disagrees. The reasoning of the court in *Banque Financière* was based on the fact that the only remedy stipulated in the MIA 1906 for breach of the duty of good faith was “avoidance”. That was deemed adequate to establish a parallel between the good faith obligation in insurance contracts and equitable concepts such as duress and undue influence; although, when viewed from the historical setting, it is clear that the role of the Court of Chancery in the development of good faith in insurance law was rather secondary. For a considerable period of time and certainly until the judiciary reforms, Chancery’s attitude in insurance cases concerning non-disclosure or misrepresentation was to refrain from exercising jurisdiction in cases where the matters alleged by the bill afforded a defence to a claim on the policy at common law. In those cases, Chancery would send an insurer’s claim for relief to the common law courts for trial.²³ It is, therefore, rather curious to suggest that the doctrine of good faith in insurance law emerges from the law of equity.²⁴ The fact that “avoidance” is not any more the only remedy stipulated by the relevant statute does not, of course, alter the origins of the doctrine, but it certainly opens the door for a fresh judicial analysis on the subject. Looking at the matter in that light, it could be easier for a court to disregard the finding of the courts in *Banque Financière* litigation on the origins of the duty.²⁵

Although the duty could be traced to common law, with the aid of the remaining part of s. 17 of the MIA, there still remain problems in identifying the scope of the duty and potential remedies in case of its breach. It is submitted that the assured’s pre-contractual duty of good faith could be instrumental in determining the scope of the insurer’s duty, given that s. 17 does not hint of any difference in the nature of these duties. If so, the insurer would presumably be required to disclose information relating to the nature and extent of the policy risks that are within the exclusive knowledge of the insurer, or information relating to the assured’s entitlement under the policy. Put differently, drawing a parallel with the assured’s pre-contractual duty of good faith, it is evidently necessary that a “materiality test” in this context be applied; and accordingly, the insurer’s obligation to speak is

²³ See *Wilson v Duckett* (1762) 3 Burr 1361 and *Duncan v Worrall* (1822) 10 Price 31.

²⁴ The part of the judgment in *Banque Financière* linking the origins of the good faith doctrine to the law of equity has often been doubted. See, for example, R. Grime, “Counterclaims by Marine Insurers” published in DR Thomas (Ed.), *Modern Law of Marine Insurance, Volume 2*, (2002, LLP) at pp. 275–275; P. Macdonald-Eggers, “Remedies for the Failure to Observe the Utmost Good Faith” [2003] LMCLQ 249, at p. 250; B. Soyer, *Marine Insurance Fraud*, (2014, Informa), at pp. 126–127.

²⁵ There are powerful dicta doubting the conclusion that the Court of Appeal reached in *Banque Financière* to the effect that remedy in case of breach of the insurer’s duty of utmost good faith was equitable in origin. For example, Lord Bingham MR in *Cox v Bankside Members Agency Ltd* [1995] CLC 671, at 680, said: “I cannot for an instant accept [counsel’s] suggestion that breach of this duty [to act with good faith in conducting legal proceedings] by an insurer, once the policy is in force, gives the assured no right other than recession.”

restricted to certain instances. There is no reason why the materiality test laid down by the Court of Appeal and endorsed by the House of Lords in *Banque Financière* could not be utilised, given that the introduction of the 2015 Act does not alter fundamentally the law's approach to parameters against which materiality is judged.²⁶

The more difficult question is what the consequence of breach of the insurer's duty of good faith would be if it proves possible to create a mutual obligation of good faith. The 2015 Act, as opposed to ss. 18 and 20 of the MIA 1906, introduces proportionate remedies in case of breach of the duty of fair presentation by the assured. For example, if the assured negligently fails to disclose a material circumstance and it can be demonstrated that the insurer would have entered into the contract but would have charged a higher premium, the insurer may reduce proportionately the amount to be paid on a claim.²⁷ Even though a remedy of this kind is made available by analogy in this context, recovering part or all of the premium paid would in most instances not be an adequate remedy for the assured following fraudulent or negligent non-disclosure on the part of the insurer. The remedy that would provide a practical benefit to an assured who is induced as a result of non-disclosure of the insurer to purchase a worthless policy or a policy that would not be of any benefit to him, is claiming damages. The prospect of a claim for damages was denied in *Banque Financière* but if it proves possible to demonstrate that the duty of good faith stems from common law, it remains a genuine possibility that courts could award damages to the assured in appropriate cases. In other common law jurisdictions courts have had no qualms in making damages available as a direct remedy for breach of utmost good faith principles.²⁸

An alternative could be that s. 17 could be utilised in arguing that a novel tort should be created allowing the assured to recover damages in cases where the insurer at the pre-contractual stage fails to observe good faith. Such an attempt did not find a sympathetic ear in *Banque Financière*. However, removal of the remedy of "avoidance" from the ambit of s. 17 has potentially altered the equation. We now face a situation where the existence of a duty on the part of the insurer to observe good faith has been recognised by a statutory provision but, unlike the pre-contractual duty of the assured, no remedy has been specified in the relevant legislation in case of its breach. It is not an uncommon occurrence for the courts to introduce new torts in appropriate instances,²⁹ and there is no risk that this new tort might work against the assured (e.g. by allowing insurers to pursue assureds

²⁶ Under s. 7(3) of the Insurance Act 2015, a circumstance or representation is deemed material "if it would influence the judgment of a prudent insurer in determining whether to take the risk and, if so, on what terms." This is almost identical to the test laid out by ss. 18(2) and 20(2) of the MIA 1906 – the provisions that were in force when the decision in *Banque Financière* was delivered.

²⁷ See s. 8 and Schedule 1 of the Insurance Act 2015.

²⁸ See, for example, *Stuart v Guardian Royal Exchange Assurance Co of New Zealand Ltd (No 2)* (1988) 5 ANZ Ins Cas 60–844.

²⁹ For example, a new tort of "breach of confidence" has been introduced in *Fraser v Thames Television* [1984] QB 44; [1998] 2 All ER 101.

for damages even in cases of innocent non-disclosure)³⁰ given that the courts will be able to determine the boundaries of this tort. Ultimately, a policy decision needs to be made as to the desirability of a new tort allowing damages when the insurer is in breach of his obligation to observe good faith at the pre-contractual stage; but it is submitted that the conditions are rather different than they were 25 years ago when *Banque Financière* was decided, and the changes made to the MIA 1906 could pave the way for a different outcome on the matter.

3.3 Post-contractual duty of good faith of the insurer

3.3.1 Role of good faith doctrine in implying obligations on the insurer

It is commonly recognised that the good faith obligations of the parties do not come to an end after an insurance contract is concluded.³¹ On several occasions, the courts have indicated that in cases where an insurer is granted a right to use his discretion by the contract, he is by virtue of the duty of good faith expected to exercise his discretion in a reasonable fashion without arbitrariness, capriciousness or perversity. In *Groom v Crocker*,³² for example, there was no doubt that a liability insurer is under an implied duty to take into account the assured's interest in handling a claim and its defence. Sir Wilfrid Greene MR expressed the legal position in an emphatic fashion:³³

The right given to the insurers is to have control of proceedings in which they and the assured have a common interest – the assured because he is the defendant and the insurers because they are contractually bound to indemnify him. Each is interested in seeing that any judgment to be recovered against the assured shall be for as small a sum as possible. It is the assured upon whom the burden of the judgment will fall if the insurers are insolvent. The effect of the provisions in question is, I think, to give to the insurers the right to decide upon the proper tactics to pursue in the conduct of the action, provided that they do so in what they bona fide consider to be the common interest of themselves and their assured. But the insurers are in my opinion clearly not entitled to allow their judgment as to the best tactics to pursue to be influenced by the desire to obtain for themselves some advantage altogether outside the litigation in question with which the assured has no concern.³⁴

³⁰ This was a concern expressed by Slade LJ at the Court of Appeal [1990] 1 QB 665, at 780.

³¹ See *The Star Sea* [2001] UKHL 1; [2003] 1 AC 469 and *The Mercandian Continent* [2001] EWCA Civ 1275; [2001] 2 Lloyd's Rep 563.

³² [1939] 1 KB 194.

³³ *Ibid.* at 203.

³⁴ Similar sentiments have been echoed by Auld LJ in *Cormack v Washbourne* [2000] CLC 1039, at 1048. The same point was also made by Longmore LJ in *The Mercandian Continent* [2001] EWCA Civ 1275; [2001] 2 Lloyd's Rep 563 at [22] in the following fashion:

Such other situations may arise under liability policies, particularly if the insurers decide to take over the insured's defence to a claim. Interests of the insured and the insurers may not be the same but they will be required to act in good faith towards each other. If for example the limit of indemnity includes sums awarded by way of damages, interest and costs, insurers may be tempted to run up costs and exceed the policy limit to the detriment of the insured. The insured's protection lies in the duty which the law imposes on the insurer to exercise his power to conduct the defence in good faith.

In a similar fashion, in the Scottish case *Fargnoli v GA Bonus plc*,³⁵ Lord Penrose expressed the view that mutuality of the obligation of good faith would require an insurer at the claims stage not to delay in bad faith an admission of liability for the settlement of claims which he would objectively be obliged to admit before a court to be valid, or which might prevent the insurer from advancing knowingly spurious defences to a claim or putting the assured to proof of what he already knows to be true. Lord Penrose was adamant that an insurer would be held to be in repudiatory breach of the contract in case of breach of this duty, again pointing to the prospect of the insurer's duty of good faith implying a contractual obligation on the assured.³⁶

The general feeling is that such an obligation is imposed on the insurer as a matter of law, perhaps in this context as a direct result of the insurer's mutual obligation of good faith.³⁷ It is, however, worth noting that no mention is made of s. 17 of the MIA 1906 in the relevant authorities. That could be due to the fact that such an obligation is implied by law in most contracts in cases where a discretion is conferred upon one of the parties and, therefore, it is not unique to insurance law. For example, in *Socimer International Bank Ltd v Standard Bank London Ltd*,³⁸ where a contract for the sale of assets between banks entrusted the task of valuation to one party, the Court of Appeal noted that the decision-maker's discretion will be limited "as a matter of necessary implication", as the decisions would have an effect on both parties; accordingly, there is a "need for the absence of arbitrariness, capriciousness, perversity and irrationality".³⁹ Similarly, in *Paragon Finance plc v Nash*,⁴⁰ where the lender was given a discretion to vary the interest rate, it was held by the Court of Appeal that the discretion is subject to an implied term that "the rates of interest would not be set dishonestly, for an improper purpose, capriciously or arbitrarily".⁴¹ It is evident from the authorities that the scope of an implied term will depend on the circumstances of the particular contract, and that could explain why in *Fargnoli v GA Bonus plc* the court indicated that the insurer must avoid acting in bad faith at the claims stage, while the degree of co-operation required from the insurer in *Groom v Crocker* was slightly more onerous. In any event, it is crystal clear that despite reference to the "mutual duty of good faith" in several cases, the source of this implied term in insurance contracts is not s. 17, so amendment to the statutory provision is unlikely to lead to any change. The case law on the subject will continue to evolve regardless.

A related but slightly different issue is the role that good faith could play in the process of implying a term into the insurance as part of the "business efficacy"

35 [1997] CLC 653, at 670–671.

36 Similar sentiments have also been echoed by HHJ Kershaw QC in *Transthene Packaging Co Ltd v Royal Insurance (UK) Ltd* [1996] LRLR 32, at 39.

37 *Eagle Star Insurance Co Ltd v Cresswell & Ors* [2004] EWCA Civ 602; [2004] Lloyd's Rep IR 537, at [54] per Rix LJ.

38 [2008] EWCA Civ 116; [2008] 1 Lloyd's Rep 558.

39 *Ibid.* at [66] per Rix LJ.

40 [2001] EWCA Civ 1466; [2002] 1 WLR 685.

41 *Ibid.* at [36] per Dyson LJ. See also *Horkulak v Cantor Fitzgerald International* [2004] EWCA Civ 1287; [2005] ICR 402.

test. The courts are willing to add a term into a contract when they reach the conclusion that the contract in question will not work in the absence of such term, so it is necessary to imply that term to give efficacy to the contract in the business sense.⁴² In a number of authorities the continuing duty of good faith has been regarded as an additional reason for implying a term into the contract in question. For example, in *Phoenix General Insurance Co of Greece SA v Halvanon Insurance Co Ltd*⁴³ it was held that in a reinsurance treaty the reinsurer had an implied right to the reassured's records insofar as they related to the covered business. Hobhouse J, put it in the following way:⁴⁴

The relevant terms have to be implied primarily so that the reassured shall conduct his business in a proper and business-like fashion, but, for the present purpose, so that the reinsurer may also be able to find out what his rights are . . . there is no ground for curtailing the obligation which would probably be imported anyway by the duty of good faith and which could also be enforced by way of discovery and inspection in any subsequent litigation.

In similar fashion, in *Goshawk Dedicated Ltd v Tyser & Co Ltd*,⁴⁵ the Court of Appeal was prepared to imply a term into the contract between the Syndicates and the assureds giving the claimant, Lloyd's Syndicate, a right to inspect and take copies of placing and claiming documents held by the brokers. Rix LJ, who delivered the judgment of the court indicated that although the implication was to be made on the traditional basis that it is necessary for business efficacy, the doctrine of good faith that applies in the insurance context supported that conclusion.⁴⁶

Although the two examples above relate to the insurer's rights against the assured, there is no doubt that in appropriate insurances – in particular, liability policies where the insurer assumes the control of the litigation – the continuing duty of good faith could form one of the justifications for implying a term into the contract setting out the obligations of the insurer. This is a role that the doctrine of utmost good faith has played prior to the amendment in s. 17 of the MIA 1906, and there is no reason to assume that the statutory amendment would lead to any change. The fact that the duty of good faith continues throughout the policy period in an insurance contract could be a critical factor in determining whether it is necessary to imply a particular term into the contract or not.

⁴² See *Liverpool City Council v Irwin* [1977] AC 239, at 254 and 262; and *Tai Hing Cotton Mill Ltd v Liu Chong Hing Bank Ltd* [1986] AC 80 at 106. The Privy Council in *Attorney General of Belize and others v Belize Telecom Ltd and another* [2009] UKPC 11 expressed the view that the proper test for deciding whether or not a term should be implied into a contract was whether it would spell out, in express words, what the contract, read against the relevant background, would reasonably be understood to mean. On that basis, it was stressed that the business efficacy test was no more than a reformulation of that question and therefore should not be treated as being different or additional test.

⁴³ [1985] 2 Lloyd's Rep 599.

⁴⁴ *Ibid.* at 614.

⁴⁵ [2006] EWCA Civ 54; [2006] 1 Lloyd's Rep 566.

⁴⁶ *Ibid.* at [53]. See also *Bonner v Cox* [2005] EWCA Civ 1512; [2006] 2 Lloyd's Rep 152; and *Goshawk Dedicated Ltd v Tyser & Co Ltd* [2006] EWCA Civ 54; [2006] 1 Lloyd's Rep 566.

3.3.2 Using good faith to restrict rights of insurers

In a number of authorities, it has been indicated that the insurer might be precluded from exercising an apparent right (e.g. the right to avoid the policy) if it is evident that the insurer has not acted in good faith whilst exercising the remedy. It was Colman J in *Strive Shipping Corporation v Hellenic Mutual War Risks Association (Bermuda) Ltd (The Grecia Express)*⁴⁷ who first brought this debate under the limelight, by suggesting that the continuing duty of good faith might place constraints on the insurer's right to avoid an insurance policy due to the assured's pre-contractual breaches of utmost good faith.⁴⁸ In that case, insurers sought to avoid a marine policy on the grounds that at the time of renewal the assured failed to disclose the fact that there were suspicious circumstances which connected the assured with previous marine casualties. Colman J held that the previous losses were not, in fact, suspicious and thus not material. However, his additional observations on the matter were very interesting. He went on to say, *obiter dictum*, that even though the suspicious circumstances may have been material facts at the inception of the policy requiring their disclosure, it would be unconscionable and contrary to the insurer's continuing duty of good faith if the insurer were to be allowed to avoid the policy based on those facts which had not been disclosed and which had been proved at the date of the purported avoidance not to have been true.⁴⁹ If it proves possible to make an inroad into the equitable concept of "unconscionability", the corollary of such a development is that the courts might be given discretion to overturn a purported avoidance at a trial stage.⁵⁰

A similar theme is apparent in *Drake Insurance plc v Provident Insurance plc*.⁵¹ The primary focus of the case was a contribution action for double insurance between two insurers; but to determine the outcome of that action it was vital to identify whether one of the insurers, namely Provident, was entitled to avoid the motor insurance policy for non-disclosure of the assured, Dr Singh. When renewing his insurance policy, Dr Singh informed his brokers of the fact that his wife, who was a named driver on the policy, was involved in an accident. This was a non-fault incident, as the car had been hit in the rear by a third party; but the incident was recorded as a fault incident on the broker's computer system until the claim was settled in Dr Singh's wife's favour. However, Dr Singh forgot to inform his brokers that he had received an SP30 speeding conviction and that his wife's claim had now been settled in her favour. Under the ranking system

47 [2002] EWHC 203 (Comm); [2002] 2 Lloyd's Rep 88.

48 There are hints in some previous authorities that the right to avoid may be fettered by a requirement of good faith. Most emphatically in *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* [1995] 1 AC 501, at 555, Lord Lloyd stipulated: "the obligation of good faith [is not] limited to one of disclosure. As Lord Mansfield said in *Carter v Boehm*, at p. 1908, there may be circumstances in which an insurer, by asserting a right to avoid for non-disclosure, would himself be guilty of want of good faith."

49 Paras. [129], [133] and [154].

50 It was convincingly argued by Professor Clarke that good faith and unconscionability should act as bars to the remedy of avoidance in some instances: "Recession: A Bridgetoo Far for Insurance Good Faith?" [2012] LMCLQ 611.

51 [2003] EWCA Civ 1834; [2004] 1 Lloyd's Rep 268.

operated by Provident, the conviction of Dr Singh would not have affected the quote if the accident of Dr Singh's wife had been reclassified as non-fault. At a later stage, Provident became aware of the speeding conviction and sought to avoid the policy for non-disclosure. It was held by the Court of Appeal that Provident could not avoid the policy. Had Provident made further investigations prior to avoiding the policy, it would have become apparent to them that the earlier accident had not been the fault of Dr Singh's wife and ought to have been left out in fixing the premium, thereby rendering the conviction alone incapable of affecting the premium.

Few would disagree with the outcome of the case, but what makes the judgment rather interesting is the fact that there are fundamental differences in the reasoning adopted by the judges. Rix and Clarke LJ based their decision on the finding that the insurer had not been induced by the non-disclosure of the speeding conviction to enter into the contract, given that the accident that Dr Singh's wife was involved in was a non-fault accident and therefore its non-disclosure could not have had any impact on the quote of the Provident under their grading system. This is a rational stand to take and was adequate to dispose the case before them. However, their Lordships went on to make observations on the impact of the insurer's continuing duty of good faith in this context. Their view was that the continuing duty of good faith would prevent the insurer from avoiding the contract if the insurer, with the knowledge (including knowledge in the shape of turning a blind eye) of the "non-fault" accident, nevertheless attempted to avoid the policy.⁵² Adopting this test, their Lordships were satisfied that avoidance in the present case had not been made in bad faith. Pill LJ, on the other hand, took a rather different stance on the matter. In his view, the continuing duty of good faith required the insurer at least to make an enquiry of the assured, offering him an opportunity to update the insurer on the accident. He continued:⁵³

All that was required was a simple enquiry as to what had happened in relation to that accident. If more than lip service is to be paid to the principle that an insurer shall show the utmost good faith, the principle in my judgment required that enquiry to be made before the "wholly one-sided" remedy of avoidance was exercised.

The majority was sympathetic to the sentiments expressed in the judgment of Pill LJ, but felt that it was a bridge too far, and Clarke LJ stressed the fact that there was no authority for the proposition that an insurer owes a duty of care to the assured to take reasonable care to make proper inquiries before avoiding the policy.⁵⁴ One should also not lose sight of the fact that Mance LJ, *obiter dictum*, in *Brotherton v Aseguradora Colseguros SA (No 2)*⁵⁵ expressed the view that, even if there may be some support for the idea that the insurer's good faith can be taken into account where allegations that a prudent insurer would have wanted to know

⁵² Ibid. at [91] per Rix LJ, and at [177] per Clarke LJ. Interestingly, both of their Lordships indicated that their observations on the role of good faith should not be regarded as part of their judgment.

⁵³ Ibid. at [177].

⁵⁴ Ibid. at [145].

⁵⁵ [2003] EWHC 335 (Comm); [2003] EWCA Civ 705; [2003] Lloyd's Rep IR 746 (CA).

about would have proven to be untrue by the time the insurer sought to avoid, this could not be applied in a case where reinsurers did not at the time of avoidance accept or know for certain of the incorrectness of the intelligence constituting the basis of their avoidance. Furthermore, he was of the view that the mere fact that a right to rescind has an equitable origin does not mean that its exercise is only possible if it is consistent with good faith or with a court's view of what is conscionable.⁵⁶

It is undisputable that the law in this area is uncertain. Despite its long history, unconscionability is relatively underdeveloped in English law. The doctrine is a broad one covering all equitable intervention, whether based on dishonesty, breach of contract or the simple innocent receipt by a donee of trust property. It is possible that Colman J was suggesting that acting in bad faith when exercising the right of avoidance amounts to unconscionable conduct, allowing the court to protect the assured (who is in a vulnerable position) by preventing the insurer from utilising this self-help remedy.⁵⁷ Regardless of the juristic origin of the duty of disclosure in insurance law, in particular whether or to what extent the origin is equitable and what role the common law played, one feels that the two prerequisites of the equitable doctrine of unconscionability, namely, the complainant's weakness and the defendant's unconscionable conduct, could be satisfied especially if the insurer acting in bad faith attempts to rely on a self-help remedy (i.e. if he knows, or is in a position to know, that he should not rely on that remedy).

Equally, the common law is well equipped to deal with a situation where an insurer in contravention of the principle of fair dealing attempts to avoid an insurance contract in the knowledge that no right of avoidance arises in the circumstances. The general principles of common law would naturally prevent the insurer in those circumstances from avoiding the contract, given that it is one of the fundamental principles of common law that everyone must act honestly towards others with whom one deals. That principle is of universal application in the common law and it does not depend on the existence of a relationship between parties based on good faith; but the fact that an insurance contract is based on mutual utmost good faith might be a relevant factor in the minds of the judges who might be tempted to use the doctrine as a bar to the insurer's right to avoid the policy.⁵⁸

Despite uncertainties surrounding the concept, it is submitted that the removal of "avoidance" as a remedy from the scope of s. 17 of the MIA 1906 is likely to yield positive results. This might allow courts to develop the concept further with the aid of the mutual duty of good faith by adopting entirely new remedies depending on different circumstances. It is true that with the introduction by the 2015 Act of proportionate remedies for breach of the assured's pre-contractual breach of good faith, instances in which the insurer will be allowed to "avoid" the contract

⁵⁶ Ibid. at [34].

⁵⁷ Conduct which is clearly against the "public policy" of the forum is sometimes described as "unconscionable conduct". See, for example, *Re Fuld (No 3)* [1968], at 698, per Scarman J.

⁵⁸ This would also be consonant with the views of the majority, Rix and Clarke LJ, expressed in *Drake Insurance plc v Provident Insurance*.

will be restricted. However, one might envisage situations where it might be necessary for the courts to intervene. For example, imagine that an insurer attempts to decline liability by using the erroneous description of the subject matter of insurance at a later stage in a case where he realises that the assured mistakenly misstated the identity of the insurance.⁵⁹ In that situation, it is possible that the insurer might be prevented from raising this defence on the premise that this would amount to breach of the insurer's duty of utmost good faith. It can also be possible that an insurer might be prevented from using its superior bargaining power to extract a disadvantageous settlement from the assured.⁶⁰

In summary, authorities have been receptive to the idea of using the utmost good faith doctrine, without attempting to define its boundaries, to prevent an insurer from acting unreasonably at the post-contractual stage. The scope of the doctrine in this context is far from being clear, but it is, at least, indisputable that an insurer attempting to rely on a remedy in the knowledge that he has no such remedy in the circumstances will be prevented from doing so. Regardless of the origin of this legal remedy (i.e. whether it stems from common law or equity), it is an indisputable fact that no reference to s. 17 of the MIA 1906 has been made by judges who have elaborated the matter so far. On that basis, it is not fanciful to suggest that there is no reason why the concept will not be developed further by reference to the statement made in s. 17 of the MIA 1906, to the effect that an insurance contract is a contract based upon utmost good faith.

3.4 Concluding remarks

Although it has received widespread acceptance that the duty of utmost good faith is mutual in nature, the development of the insurer's duty of good faith has been hampered due to the fact that s. 17 has been viewed as the source of that duty, bringing the unfitting remedy of "avoidance" into play in case of its breach. It is submitted that the change introduced in the wording of this statutory provision could potentially open the door for the courts to engage in a more sober analysis of the origins and nature of this duty.

There is no obstacle any more for the courts which might be minded to penalise an insurer who fails to draw the attention of the assured to limitations of coverage offered by the policy by tracing the origins of the concept of good faith to common law, as its historical setting suggests.⁶¹ This would still require the judges to utilise by analogy the rules set out by the 2015 Act on the assured's duty of fair presentation in determining the scope of the doctrine, but this should not pose any problem. More fundamentally, this kind of analysis will facilitate the introduction of new remedies, such as damages, which will yield a practical benefit to an

⁵⁹ In that case, the insurer could potentially argue that the policy has never attached. See *AF Watkinson & Co Ltd v Hullett* (1938) 61 LILR 145.

⁶⁰ See the comments of Rix J in *Royal Boskalis Westminster NV v Mountain* [1997] LRLR 523, at 600.

⁶¹ See, for example, *Kelly v New Zealand Insurance Co Ltd* 1996 9 ANZ Ins Cas 61-317 (FCWA).

assured who is harmed by his insurer's failure to observe good faith at the pre-contractual stage.

In the post-contractual context, the duty could be useful in determining whether there is a need to imply a term in the contract to protect the interests of the assured. In a similar vein, an insurer who decides to rely on a contractual right in an unreasonable fashion⁶² might be prevented from doing so by general principles of common law, and even perhaps through the intervention of equity principles.

These developments should not be viewed as extraordinary or exceptional. In other types of contracts where parties are expected to observe good faith, courts seem to be happy to contemplate various remedies in case of breach of such obligations. For example, in partnership contracts, parties acting in bad faith could be prevented from pleading what would otherwise amount to a defence to a claim.⁶³ In insurance contracts, the law should have developed in a similar fashion, but for many years s. 17 and the remedy of "avoidance" has halted any attempt to develop the doctrine of utmost good faith of the insurer. Now the path has been cleared, and one should not be surprised to see the doctrine evolving at the hands of the judiciary in the years to come.

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⁶² See, for example, *Massoud v NRMA Insurance* (1995) 62 NSWLR 657.

⁶³ *Clements v Hall* (1858) 2 De. G & J 173.