Swansea University E-Theses

Fraudulent claims in commercial insurance law: A legal and economic analysis.

Zheng, Rui

How to cite:

Zheng, Rui (2012) *Fraudulent claims in commercial insurance law: A legal and economic analysis..* thesis, Swansea University.
http://cronfa.swan.ac.uk/Record/cronfa42644

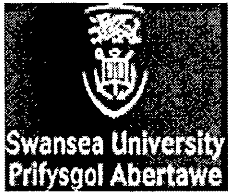
Use policy:

This item is brought to you by Swansea University. Any person downloading material is agreeing to abide by the terms of the repository licence: copies of full text items may be used or reproduced in any format or medium, without prior permission for personal research or study, educational or non-commercial purposes only. The copyright for any work remains with the original author unless otherwise specified. The full-text must not be sold in any format or medium without the formal permission of the copyright holder. Permission for multiple reproductions should be obtained from the original author.

Authors are personally responsible for adhering to copyright and publisher restrictions when uploading content to the repository.

Please link to the metadata record in the Swansea University repository, Cronfa (link given in the citation reference above.)

http://www.swansea.ac.uk/library/researchsupport/ris-support/



Swansea University

FRAUDULENT CLAIMS IN COMMERCIAL INSURANCE LAW: A LEGAL AND ECONOMIC ANALYSIS

By

RUI ZHENG

LL.M (Swansea, Dist.)

LL.B (Renmin University of China, Beijing)

This Thesis is submitted to Swansea University in fulfillment of the requirements for the Degree of Doctor of Philosophy

School of Law

Swansea University

AUGUST 2012

ProQuest Number: 10805420

All rights reserved

INFORMATION TO ALL USERS
The quality of this reproduction is dependent upon the quality of the copy submitted.

In the unlikely event that the author did not send a complete manuscript
and there are missing pages, these will be noted. Also, if material had to be removed,
a note will indicate the deletion.

ProQuest 10805420

Published by ProQuest LLC (2018). Copyright of the Dissertation is held by the Author.

All rights reserved.
This work is protected against unauthorized copying under Title 17, United States Code
Microform Edition © ProQuest LLC.

ProQuest LLC.
789 East Eisenhower Parkway
P.O. Box 1346
Ann Arbor, MI 48106 – 1346

TO MY FAMILY

Swansea University

School of Law

Doctor of Philosophy

FRAUDULENT CLAIMS IN COMMERCIAL INSURANCE LAW: A LEGAL AND ECONOMIC ANALYSIS

ABSTRACT

Insurance fraud is perhaps one of the most pressing problems challenging the insurance industry. The judiciary plays a significant role in tackling insurance fraud: the burden is on their shoulders to identify the appropriate legal rules governing fraudulent claims and determining the consequences of fraud. However, regrettably, this process has long remained elusive and in the recent decades the courts have tried but failed to formulate clear principles for the treatment of insurance fraud, so the process is, still, continuing. This judicial process is not free from difficulty particularly with regard to the consequence of presenting fraudulent claims. The failure of judicial attempt to formulate clear principles in this jurisdiction has attracted the attention of the Law Commissions which intend to pursue a reform at the legislative level.

At the current stage, the law seems to stand at a turning point and try to adapt itself to the new situation. The author is of the opinion that this is the right time to provide a full-scale research in the jurisdiction of insurance fraudulent claims for the purpose of identifying the existing difficulties and confusions, shaping the appropriate legal regime and contributing to the evolving reform process of English insurance contract law. The author is also of the opinion that considering the viability of reform proposals from a novel perspective, namely economics and law, might add a very interesting dimension to the debate. It is believed that the law and economics debate would be helpful in explaining the outcomes of certain legal solutions and identifying the most appropriate legal remedy. Finally, the author also intends to examine to what extent the Law Commissions' proposal could be defended in the light of author's legal and economic analysis.

Declaration and Statements

DECLARATION

This work has not previously been accepted in substance for any degree and is not being concurrently submitted in candidature for any degree.

Signed ....Rui Zheng..

Date ....10/08/2012..

STATEMENT 1

This thesis is the result of my own investigations, except where otherwise stated. Where correction services have been used, the extent and nature of the correction is clearly marked in a footnote(s).

Other sources are acknowledged by footnotes giving explicit references. A bibliography is appended.

Signed ....Rui Zheng..

Date ....10/08/2012..

STATEMENT 2

I hereby give consent for my thesis, if accepted, to be available for photocopying and for inter-library loan, and for the title and summary to be made available to outside organisations.

Signed ....Rui Zheng...

Date ....10/08/2012..

NB: *Candidates on whose behalf a bar on access has been approved by the University (see Note 7), should use the following version of Statement 2:*

I hereby give consent for my thesis, if accepted, to be available for photocopying and for inter-library loans **after expiry of a bar on access approved by the Swansea University.**

Signed ....Rui Zheng.................................

Date ....10/08/2012...

TABLE OF CONTENTS

TABLE OF CONTENTS i
TABLE OF STATUES viii
TABLE OF OVERSEAS LEGISLATION x
ABBREVIATIONS xi
ACKNOWLEGEMENTS xvi

INTRODUCTION 1
I. OUTLINE AND OBJECTIVES 1
II. METHODOLOGICAL ISSUES 7
A. The Study of Case Law 7
B. Jurisprudential Analysis 8
C. Economic Analysis 9
III. STRUCTURE OF THE THESIS 10

PART ONE
CHAPTER ONE: THE DEFITION OF FRAUD IN GENERAL 13
Introduction 13
I. The Falsity of the Representation 16
A. The meaning of representation 16
B. The falsity of the representation 24
II. The Fraudulent Knowledge and the Intention of the Representor 27
A. The first limb of fraudulent knowledge: actual knowledge 29
(a) Attributing agent's knowledge to the principal 29
(b) Attributing employee's knowledge to the company: the *alter ego* of the company 32
B. The second limb of fraudulent knowledge: recklessness 36
C. The fraudulent intention of the representor 41
(a) The representation must be addressed to the misled representee 42
(b) Motive is generally irrelevant 43

Conclusion.. 45

CHAPTER TWO: THE DEFINITION OF FRAUD IN INSURANCE CLAIMS CONTEXT..46

Introduction.. 46

I. Wilful Fabrication of the Claim.. 48

II. Exaggeration of the Claim.. 58

A. Exaggeration must be substantial.. 59

(a) The meaning of substantiality.. 59

(b) The difference between "substantiality" and "materiality"......... 63

B. Figures for negotiation is not usually fraudulent.......................... 65

C. The limitation of the concept of "figures for negotiation"............... 67

III. The Use of Fraudulent Devices or Means.................................. 69

A. The meaning of fraudulent devices or means and the appropriate tests.. 69

B. The recent development of case law.................................. 74

IV. Fraudulently Suppressing the Defence.................................. 85

V. Fraudulently Maintaining an Initially Honest Claim.......................... 88

VI. Miscellaneous: Fraud in Composite and Joint Policies.......................... 89

CHAPTER THREE: BURDEN OF PROOF IN CIVIL FRAUD ALLEGATIONS..91

I. Strong Evidence Required..91

II. Standard of Proof and Burden of Proof.................................. 93

III. Fraud Indicators.. 102

CHAPTER FOUR: THE EVALUATION OF VARIOUS REMEDIES FOR PRESENTATION OF FRAUDULENT CLAIMS.................................. 107

Introduction.. 107

I. The Common Law Rule of Forfeiture.................................. 108

A. Introduction.. 108

B. *AXA General Insurance Ltd v Gottlieb*: the scope and effect of the common law rule.. 111

C. *Super Chem Products Ltd v American Life and General Insurance Co.Ltd.*: the relationship between common law rule and other contractual defence in the insurance policy........................ 114

D. Conclusions.. 116

II. The Fraudulent Claims Clauses.. 119

A. Introduction.. 119

B. Interpretation of clauses and consequences of breach.................. 122

(a) Void/Avoid.. 122

(b) Forfeited/Forfeiture...128

(c) Condition precedent... 130

(d) Warranty.. 137

C. Conclusions.. 139

III. The Implied Contractual Approach... 140

A. The basis for implying a term requiring insured not to submit fraudulent claims.. 141

(a) Implication in fact or Implication by law?.............................. 141

(b) The policy concerns supporting the implication...................... 145

(c) The conflict between implied terms and express terms............. 149

B. The characteristic of the implied terms not to submit fraudulent claims.. 150

(a) The impact of fraud on the validity of the contract from the perspective of general contract law.. 150

(b) The discussion in the context of insurance contract................ 152

C. The possibility of claiming damages.. 155

IV. The Duty of Good Faith.. 160

A. Duty of utmost good faith continues after the formation of contract: From *The Litsion Pride* to *The Mercandian Continent*................ 161

(a) *Black King Shipping Corporation v Massie (The Litsion Pride)*.. 163

(b)*Bank of Nova Scotia v Hellenic Mutual War Risks Association (The Good Luck)*.. ...165

(c) *Manifest Shipping and Co Ltd v Uni-Polaris Insurance Co (The Star Sea)* .... .167

(d) *K/S Merc-Scandia V. Lloyd's Underwriters (The Mercandian Continent)* 170
B. The policy concerns supporting the presentation of fraudulent claims being a breach of continuing duty of utmost goods faith 172
C. Current remedy available for breach of post-contractual duty of good faith: avoidance *ab initio* 174
D. Restriction on avoidance 177
(a) Loss of right to avoid the policy following a fraudulent claim 177
(b) The *Mercandian Continent* Test 180
(c) Judicial flexibility: discretion to disallow avoidance 184
(d) The availability of damages for breach of post-contractual duty of good faith 193
V. The Summary of Current Legal Status 199
VI. The Policy Evaluations Regarding the Selection of Appropriate Remedies 201
A. The demand for various liability regimes: the conflict between certainty and flexibility 201
B. Reconsideration of the principle of good faith in post-contractual context 207
Conclusions 214

PART II
CHAPTER FIVE: ECONOMIC ANALYSIS ON FRAUDULENT CLAIMS IN COMMERCIAL INSURANCE-WITH PARTICULAR EMPHASIS ON REMEDIES 216
I. Methodology: The New Trend of Legal Research and the Possibility of Economic Evaluations on the Fraudulent Claims in Commercial Insurance Law 216
II. The Economic Evaluation of Section 17 in Post-contractual Context 221
A. The informational asymmetry in insurance contract and the comparison of economic function of Section 17 in the pre-contractual and the post-contractual stage 221
(a) An introduction to informational asymmetry 221

(b) Informational symmetry in the pre-contractual stage of insurance contract... 224
(c) Informational symmetry in the post-contractual stage of insurance contract: the important role of investigation.......................... 225
(d) Conclusions... 229
B. The economic insight of the remedy provided by Section 17 in post-contractual stage...230
C. Conclusions... 235
III. The Economic Evaluation of the Contractual Approach....................... 236
A. Introduction: the function of contract law in deterring the opportunistic behaviours...236
B. The economic insight of express fraudulent claim clause............... 236
C. The economic insight of implied fraudulent claim clause............. 244
D. Conclusions... 246
IV. The Incentive Contractual Arrangements for the Purpose of Deterring the Fraudulent Claims...246
A. Partial insurance...247
(a) Coinsurance...247
(b) Insurance with deductibles...248
B. Bonus-Malus Insurance... 250
C. The economic functions of notification clauses............................ 251

<u>PART III</u>

CHAPTER SIX: THE EVALUATION ON LAW COMMISSIONS' PROPOSED REFORMS OF THE LAW OF INSURERS' REMEDIES FOR FRAUD....... 254
I. Background... 254
II. Preliminary Considerations of the Reform.................................. 256
III. Analysis on the Law Commissions' Proposed Statutory Provision....... 263
A. Forfeiture of the whole claim to which the fraud relates............... 263
B. Forfeiture of subsequent claims... 265
C. No Avoidance of previous valid claim...................................... 273
D. Damages...273
E. Miscellaneous: fraud in co-insurance and group insurance.......... 277
IV. Conclusions... 278

CONCLUSIONS..278

BIBLIOGRAPHY..289

APPENDICES

MARINE INSUANCE ACT 1906.. 298

THE LAW COMMISSIONS: SECOND CONSULTATION PAPER IN JOINT INSURANCE LAW PROJECT: INSURNACE CONTRACT LAW: POST CONTRACT DUTIES AND OTHER ISSUES (CHAPTER 2: INSURERS' REMEDIES FOR FRAUD)..331

TABLE OF CASES

Achilleas, The. See Transfield Shipping Inc. *v* Mercator Shipping Inc.
Abram Steamship Co Ltd *v* Westville Shipping Co Ltd [1923] AC 773........... **[4.127]**
Agapitos *v* Agnew [2002] 2 Lloyd's Rep 42..............................**[2.3],[2.16],[2.19],[2.28],[2.30][2.33],[2.37],[2.44],[3.2],[4.5], [4.7], [4.35],[4.36],[4.37],[4.101], [4.116],[6.4],[6.5]**
AIC Ltd *v* ITS Testing Services (UK) Ltd (The Kriti Palm) [2007] 1 Lloyd's Rep.555.. **[1.4], [1.5]**
Akerhielm *v* De Mare [1959] AC 789... **[1.14]**
Aktielskabet Greenland *v* Janson (1918) 35 TLR 135................................. **[4.40]**
Alexion Hope, The [1987] 1 Lloyd's Rep. 60; [1988] 1 Lloyd's Rep 311 (CA).. **[2.46], [3.8]**
Alfred McAlpine *v* BAI (Run-Off) Ltd [1998] 2 Lloyd's Rep.694, 70................ **[4.32]**
Amer Energy, The. See ASM Shipping Ltd of India *v* TTMI Ltd of England
American Life and General Insurance Co.Ltd. [2004] UKPC 2; [2004] 2 ALL ER 358.. **[4.11]**
Anglo-Scottish Beet Sugar Corporation Ld. *v*. Spalding Urban District Council [1937] 2 KB 607, 621.. **[1.19]**
Angus *v* Clifford [1891] 2 Ch 449... **[1.27]**
Annefield, The [1971] 1 Lloyd's Rep.1... **[4.21]**
Arab Bank plc *v* Zurich Insurance Co [1999] 1 Lloyd's Rep.262 ....**[2.47]**
Argo Systems FZE *v* Liberty Insurance [2011] EWCA.............................. **[6.13]**
Arkwright *v* Newbold (1881) 17 Ch D 301.. **[1.15]**
Armitage *v* Nurse [1998] 1 Ch 241.. **[1.18], [1.26]**
Armstrong *v* Strain [1951] 1 TLR 856; [1952] 1 KB 232..............................**[1.19]**
Arrow Nominees Inc *v* Blackledge [2000] 2 BCLC 167............................ **[4.159]**
ASM Shipping Ltd of India *v* TTMI Ltd of England (The Amer Energy) [2009] 1 Lloyd's Rep.293.. **[4.74]**
Aspen *v* Pectel [2008] EWHC 2804 (Comm)... **[5.58]**
Associated Japanese Bank (International) *v* Credit du Nord SA [1989] 1 WLR 255.. **[4.48]**
Attorney General *v* Blake [2001] 1 AC 268.. **[4.138]**
Aviva Insurance Ltd *v* Brown [2011] EWHC 362 .(QB)....................... **[1.2], [1.3], [1.27], [1.32], [2.37], [6.5], [6.8]**
Avon Insurance plc *v* Swire Fraser Ltd [2000] 1 ALL ER (Comm) 573............ **[1.15]**
AXA General Insurance Ltd *v* Gottlieb [2005] Lloyd's Rep.IR 369..................................**[4.6], [4.7], [4.27], [4.33], [4.159], [5.44], [6.8], [6.9]**
Baden *v*. Société Générale pour Favoriser le Développement du Commerce et de l'Industrie en France S.A. (Note) [1993] 1 WLR 509 [250] .... **[1.17]**
Baghbadrani *v* Commercial Union [2000] Lloyd's Rep.IR.94............. **[4.108], [6.13]**
Bamcell II, The (1980) 133 DLR (3d) 727; [1983] 2 SCR 47......................... **[4.40]**
Bank of Nova Scotia *v* Hellenic Mutual War Risks Association (Bermuda) Ltd (The Good Luck) [1990] 1 QB 818; [1991] 2 Lloyd's Rep.191.............. **[4.117], [4.137], [4.39], [4.69], [4.85], [4.86], [4.33], [6.11]**
Beresford *v* Royal [1938] AC 586.. **[2.7]**
Bilbie *v* Lumley (1802) 2 East.469..**[1.11]**

Bisset *v* Wilkinson [1927] AC 177.. **[1.9]**
Black King Shipping Corporation *v* Massie (The Litsion Pride) [1985] 1 Lloyd's Rep.437.. **[4.81]**, **[4.82]**, **[4.83]**
Blackburn Low & Co *v* Vigors (1887) 12 App Cas 531................................ **[1.25]**
Bradford Third Equitable Benefit Building Society *v* Borders [1941] 2 ALL ER 205.. **[1.31]**
British and Foreign Marine Insurance Co v Gaunt [1921] 2 AC 41.................. **[3.8]**
British Sugar plc *v* NEI Power Projects Ltd [1997] 87 BLR 42.......................... **[4.20]**
Britton *v* Royal Insurance Company (1866) 4 F&F 905................................. **[4.4]**
Brotherton *v* Aseguradora Colseguros [2003] EWCA Civ.705; [2003] 2 C.L.C. 629.. **[4.123]**
Brownlie *v* Campbell (1880) 5 App Cas 925.. **[1.16]**
Buana Dua, The. See PT Buana Samudra Pratama *v* Marine Mutual Insurance Association (NZ) Ltd
Bucks Printing Press *v* Prudential Assurance Unreported: Commercial Court, 26 February 1991, Saville J.. **[2.42]**
Bunge Corporation New York *v* Tradax Export SA [1981] 2 Lloyd's Rep.1..... **[4.144]**
Callaghan and Hedges *v* Thompson [2000] 1 Lloyd's Rep.125...................... **[4.111]**
Camarata Property *v* Credit Suisse Securities [2011] EWHC 479..................... **[1.28]**
Captain Panagos DP, The. See Continental Illinois National Bank & Trust Co. of Chicago and Xenofon Maritime SA *v* Alliance Assurance Co. Ltd.
Chantiers De L'Atlantique SA *v* Gaztransport & Technigaz SAS [2011] EWHC 3383 (Comm)... **[4.159]**
Carter *v* Boehm (1766) 3 Burr.1905....... **[4.19]**, **[4.78]**, **[4.100]**, **[4.104]**, **[5.13]**, **[5.25]**
Chapman *v* Pole (1870) 22 LT 306.. **[4.105]**
Charter Reinsurance Co Ltd *v* Fagan [1997] AC 313............................ **[5.39]**, **[6.6]**
Classic Maritime Inc. *v* Lion Diversified Holdings Berhad [2010] 1 Lloyd's Rep.59.. **[4.74]**
Commercial Union Assurance Co. Ltd *v* The Niger Co.Ltd (1922) 13 LI.L.Rep.75.. **[4.129]**, **[5.25]**
Commissioner for the New Towns *v* Cooper (Great Britain) Ltd [1995] Ch 259.. **[1.17]**
Connolly Ltd *v* Bellway Homes Ltd [2007] EWHC 895 (Ch)............................ **[2.24]**
Continental Illinois National Bank & Trust Co. of Chicago and Xenofon Maritime SA *v* Alliance Assurance Co. Ltd. (The Captain Panagos DP) [1986] 2 Lloyd's Rep.470, 511.. **[2.40]**,**[4.66]**
Copa Casino, The. See Argo Systems FZE *v* Liberty Insurance
Crossley *v* Faithful&Gould Holdings Ltd [2004] 4 ALL ER 447...................... **[4.53]**
Crystal Palace FC (2000) Ltd *v* Dowie [2007] EWHC 1392 (QB) .... **[1.8]**
Danepoint Ltd *v* Underwriting Insurance Ltd.[2006] Lloyd's Rep.IR.429..**[2.19]**,**[2.24]**
Davies *v* London and Provincial Marine Insurance Co (1878) Ch D 469........... **[1.16]**
Dawson *v* Monarch Insurance Co of NZ Ltd [1977] 1 NZLR.372..................... **[2.22]**
Derry *v* Peek (1899) 14 App Cas 337............................ **[1.2]**, **[1.17]**, **[1.23]**, **[2.1]**
Dimmock *v* Hallett (1866) LR 2 Ch App 21.. **[1.15]**
Direct Line Insurance Plc *v* Fox [2009] EWHC 386 (QB)......................... **[2.33]**, **[4.13]**
Direct Line *v* Khan [2001] Lloyd's Rep.IR.364.. **[2.46]**, **[4.7]**
Director General of Fair Trading *v* First National Bank [2001] 1 AC 481......... **[4.149]**
Dome Mining Corp Ltd *v* Drysdale (1931) 41 LIL.Rep.109.................... **[2.24]**, **[3.2]**
Donoghue *v* Stevenson [1932] 1 AC 562.. **[1.26]**

Drake Insurance Plc (in Provisional liquidation) *v* Provident Insurance Plc [2004] 1 Lloyd's Rep.268 (CA)........................ **[2. 37], [4.126], [4.127], [4.138], [4.155]**
Eagle Star Insurance Co Ltd *v* Games Video Co (GVC) SA (The Game Boy) [2004] 1 Lloyd's Rep.238.. **[2.30], [4.13]**
Eaglesfield *v* Londonderry (Marquis) (1876-1877) 4 Ch D 693..................... **[1.11]**
Economides *v* Commercial Union Assurance Co.plc [1997] 3 WLR 1066.......... **[1.9]**
Edgington *v* Fitzmaurice (1885) 29 Ch D 459 [1.10].................................. **[1.31]**
EE Caledonia Ltd. *v* Orbit Valve Co Europe [1993] 4 ALL ER 165................ **[4.17]**
Entwells Pty Ltd *v* National and General Insurance Co Ltd (1991) 6 WAR 68..... **[2.17]**
Equitable Life Assurance Society *v* Hyman [2002] 1 AC 408......................... **[4.49]**
Ert Setfanie, The. [1989] 1 Lloyd's Rep.349.. **[1.20]**
Esso Petroleum co Ltd *v* Mardon [1976] QB 801.. **[1.9]**
Eurysthenes, The [1976] 2 Lloyd's Rep.171.. **[2.12]**
Fairclough Homes Limited *v* Summers [2012] UKSC 26............................ **[4.159]**
Fargnoli *v* G A Bonus Plc [1997] CLC 653.. **[4.73]**
Fiona Trust & Holding Corp *v* Privalov [2008] 1 Lloyd's Rep.254.................. **[4.12]**
Forder *v* Great Western Railway Co. [1905] 2 K.B. 532.............................. **[2.8]**
Friends Provident Life & Pensions Ltd *v* Sirius International Insurance [2005] 2 Lloyd's Rep.517.. **[4.33], [4.69], [5.58]**
Galloway *v* Guardian Royal Exchange (UK) Ltd [1999] Lloyd's Rep.IR 209.. **[2.16], [2.18], [4.88], [4.98], [4.106]**
Game Boy, The. See Eagle Star Insurance Co Ltd v Games Video Co (GVC) SA
General Ins Co of Trieste *v* Cory [1897] 1 QB 335.................................... **[5.50]**
Golden Straight Corporation *v* Nippon YKK (The Golden Victory) [2007] UKHL 12.. **[4.142], [6.16]**
Golden Victory, The. See Golden Straight Corporation v Nippon YKK
Goldsmith Williams (A Firm) *v* Travelers Insurance Co Ltd [2010] Lloyd's Rep. IR.309.. **[6.5]**
Good Luck, The. See Bank of Nova Scotia v Hellenic Mutual War Risks Association (Bermuda) Ltd
Gordon *v* Selico Ltd (1986) 18 H.L.R. 219... **[1.7]**
Gorss *v* Lewis Hillman [1970] Ch 445.. **[1.31]**
Goulstone *v* Royal Insurance Company (1858) 1 F&F 276.................. **[2.15], [4.4]**
Graham Joint Stock Shipping Co Ltd *v* Merchants' Marine Insurance Co (1923) 17 LIL Rep.44.. **[2.46]**
Graham *v* Belfast and Northern Counties Railway Co.[1901] 2 I.R.13............... **[2.8]**
Grave *v* GA Bonus [1999] 2 Lloyd's Rep.716.. **[3.9]**
Grosvenor Casinos Ltd *v* National Bank of AbuDhabi [2008] 2 Lloyd's Rep.1.... **[1.27]**
Guardian Royal Exchange *v* Ormsby [1982] 29 SASR 498......................... **[2.19]**
Hadley *v* Baxendale (1854) 156 ER 145.......................... **[4.73], [4.138], [6.12]**
Hamilton *v* Mendes (1761) 2 Burr 1198.. **[2.38]**
Harbour Assurance Co (UK) Ltd *v* Kansa General International Insurance Co Ltd [1993] 1 QB 701.. **[4.12]**
Herbert Morris Ltd *v* Saxelby [1916] 1 AC 688...................................... **[3.1]**
HIH Casualty & General Insurance Ltd *v* Axa Corporate Solutions [2002] Lloyd's Rep IR 325.. **[6.13]**
HIH Casualty & General Insurance Ltd *v* New Hampshire Insurance Co and others [2001] 2 Lloyd's Rep.161.. **[4.40]**
HIH Casualty and General Insurance Ltd.*v* Chase Manhattan Bank [2003] 2 Lloyd's Rep.61.. **[1.22], [4.79], [6.6]**

Hong Kong Fir Shipping *v* Kawasaki Kisen Kaisha [1962] 2 QB.......... **[4.65], [4.144]**
Hornal *v* Neuberger Products Ltd [1957] 1 QB 247.................................... **[3.5]**
Ikarian Reefer, The [1995] 1 Lloyd's Rep.455.................................. **[3.5], [3.8]**
Inclusive Technology *v* Williamson [2009] EWCA Civ 718......................... **[1.10]**
Inntrepreneur Pub.Co *v* Sweeney [2002] EWHC 1060 (Ch)......................... **[1.10]**
Insurance Corp of the Channel Islands *v* McHugh and Royal Hotel Ltd [1997] LRLR 94... **[4.16],[4.26]**
Insurance Corp of the Channel Islands *v* Royal Hotel Ltd [1998] Lloyd's Rep. IR.151... **[4.111]**
Interpart Comerciao e Gestaao SA *v* Lexington Insurance [2004] Lloyd's Rep.IR.690 ....**[2.28]**
Islington London Borough Council *v* Uckac [2006] 1 WLR 1303................... **[4.19]**
J Spurling Ltd *v* Bradshaw [1956] 1 WLR 461.. **[6.6]**
Johnstone *v* Bloomsbury Area Health Authority [1991] 2 WLR 1362............. **[4.62]**
Joseph Fielding Properties (Blackpool) Limited *v* Aviva Insurance Limited [2010] EWHC 2192 (QBD).. **[2.35], [4.16], [4.24], [6.6]**
Jureidini *v* National British and Irish Miller Insurance [1915] AC 499.............. **[4.10]**
K/S Merc-Scandia *v*. Lloyd's Underwriters (The Mercandian Continent) [2000] 2 Lloyd's Rep.357; [2001] 2 Lloyd's Rep.563 .... **[4.93], [4.94], [4.95], [4.114], [4.115], [4.116], [4.117], [4.118], [4.119], [4.120], [6.4]**
Kanchenjuna, The [1990] 1 Lloyd's Rep.391... **[6.13]**
KBC Bank *v* Industrial Steels (UK) Ltd [2001] 1 Lloyd's Rep.370................. **[1.32]**
Kleinwort Benson Ltd. *v* Lincoln City Council [1999] 2 AC 349.................... **[1.11]**
Kleinwort Benson Ltd. *v* Malaysia Mining Corporation Berhad [1989] 1 WLR 379 ....**[1.10]**
Kosmar Villa Holidays *v*. Syndicate 1243 [2008] Lloyd's Rep IR 489............ **[6.13]**
Krakowski *v* Eurolynx Properties Ltd [1994] HCA 22.............................. **[1.14]**
Kriti Palm, The. See AIC Ltd v ITS Testing Services (UK) Ltd.
Kuddus *v* Chief Constable of Leicestershire [2002] 2 AC 122........................ **[4.75]**
Kumar *v* Life Insurance Corporation of India [1974] 1 Lloyd's Rep.147........... **[4.23]**
L.Schuler AG *v* Wickman Machine Tool Sales [1974] AC 235....................... **[4.22]**
L' Estrange *v* E.Graucob Ltd [1934] 2 KB 394.. **[6.6]**
La Banque Financiere de la Cité S.A. *v* Westgate Insurance Co.Ltd [1987] 1 Lloyd's Rep.69; [1988] 2 Lloyd'sRep.513; [1990] 2 Lloyd's Rep.377............. **[4.133], [6.15]**
Laceys Footwear (Wholesale) Ltd. *v* Bowler International Freight Ltd. and Another [1997] 2 Lloyd's Rep.369... **[2.8]**
Lady Gwendolen, The. [1965] 1 Lloyd's Rep.335.. **[1.20]**
Langridge *v* Levy (1838) 4 M&W 337.. **[1.31]**
Lazarus Estates Ltd *v* Beasley [1956] 1 QB 702.. **[1.12]**
Le Lievre *v* Gould [1893] 1 QB 491.. **[1.28]**
Lehmbackers Earth Moving and Excavators *v*. Incorporated General Insurance (1984) 3 SA 513 AD.. **[4.27]**
Lek *v* Mathews (1927) 29 Ll.L.Rep.141.............................. **[2.3], [2.15], [4.16]**
Lennard's Carrying *v* Asiatic Petroleum [1915] AC 705............................. **[1.20]**
Leonita, The (1922) 13 Ll.L. Rep. 231... **[3.15]**
Liberian Insurance Agency Inc. *v* Mosse [1977] 2 Lloyd's Rep.560............... **[4.88]**
Litsion Pride, The. See Black King Shipping Corporation v Massie
Liverpool City Council *v* Irwin [1977] AC 239.................................. **[4.47], [4.51]**
Lloyd *v* Grace Smith [1912] AC 716.. **[1.19]**

Lockyer *v* Offley (1776) 1 T.R.252.. **[4.142]**
London Assurance *v* Clare (1937) 57 Ll L Rep.254 .... **[4.71], [6.15], [6.18]**
Loyaltrend *v* Brit [2010] EWHC 425 (Comm)... **[5.57]**
Luxor (Eastbourne) Ltd *v* Cooper [1941] AC 108....................................... **[4.46]**
Lynch *v* Thorne [1956] 1 WLR 303... **[4.59]**
Manifest Shipping Co Ltd *v*. Uni-Polaris Insuance Co.Ltd and La Reunion Europeene (The Star Sea) [2001] 1 Lloyd's Rep.389...**[1.20]** **[2.2],[2.13],[2.28], [2.38], [4.1],[4.2],[4.5], [4.7], [4.14],[4.19],[4.20],[4.23],[4.70],[4.88],[4.89],[4.91],[4.92],[4.115],[4.117],[4.118], [4.138], [5.23], [5.25], [6.1], [6.4]**
Marc Rich Agriculture Trading SA *v* Fortis Corporate Insurance NV [2005] Lloyd's Rep.IR.396.. **[2.29], [2.43]**
Medd *v* Cox (1940) 67 Ll.L.Rep.5... **[1.24]**
Mercandian Continent, The. See K/S Merc-Scandia *v*. Lloyd's Underwriters
Melik *v* Norwich Union Fire Insurance Society Ltd [1980] 1 Lloyd's Rep.523.... **[6.13]**
Meridian Global Funds Management Asia Ltd *v* The Securities Commission [1995] 2 AC 500.. **[1.20]**
Michael, The. See Piermay Shipping Co. S.A. And Brandt's Ltd. V. Chester
Midland Silicone Ltd *v* Scrttons Ltd [1962] AC 446.................................. **[4.154]**
Mihalis Angelos, The. See Naviera SA v Bergbau-Handel GmbH
Milasan, The. [2000] 2 Lloyd's Rep.458...... **[3.9], [3.11], [3.12], [3.13], [3.14], [3.15]**
Moens *v* Heyworth (1842) 10 M&W 147, 158... **[1.14]**
Moore Stephens *v* Stone &Rolls Ltd, Re Hampshire Land [2009] 1 AC 1391..... **[1.21]**
Moore *v* Evans [1917] 1 KB 458.. **[2.45]**
Muirhead *v* Forth&North Sea Steamboat Mutual Ins Assn [1894] AC 72.......... **[5.49]**
Naviera SA *v* Bergbau-Handel GmbH (The Mihalis Angelos) [1970] 2 Lloyd's Rep.43.. **[4.144]**
Nocton *v* Lord Ashburton [1914] AC 932.. **[1.2]**
Nottingham Patent Brick and Tile Co *v* Butler (1886) 16 QBD 778................. **[1.15]**
Nsubuga *v* Commercial Union Assurance Co plc [1998] 2 Lloyd's Rep.682....... **[2.21]**
O'Brien *v* MGN Ltd [2001] EWCA Civ 1279.. **[6.6]**
OBG Ltd *v* Allan [2008] 1 AC 1.. **[1.31]**
Ocean Chemical Transport Inc *v* Exnor Craggs Ltd [2000] 1 ALL ER (Comm) 519 .... **[6.6]**
Olympia, The (1924) 19 LlL.Rep.255...**[3.12], [3.13]**
Orakpo *v* Barclays Insurance Services [1995] LRLR 443........................ **[2.16], [2.20], [4.88], [4.118]**
Overseas Commodities Ltd. *v* Style [1958] 1 Lloyd's Rep. 437...................... **[4.88]**
Pan Atlantic Insurance Co Ltd *v* Pine Top Insurance Co. Ltd [1993]1 Lloyd's Rep.496; [1995] 1 AC 501.................... **[2.19] [4.37], [4.97], [4.121], [4.130], [4.135], [6.16]**
Pankhania *v* Hackney London Borough Council [2002] EWHC 2441 (Ch)........ **[1.11]**
Papadimitriou *v* Henderson (1939) 64 Ll.L.Rep.345................................. **[2.10]**
Paterson *v* Harris (1861) 1 B&S 336... **[5.53]**
Pawson *v* Watson (1778) 2 Cowp 786.. **[4.19]**
Peek *v* Gurney (1873) LR 6 HL 377....................................... **[1.7] [1.15] [1.37]**
Pettit *v* Pettit [1969] 2 ALL ER 385.. **[6.5]**
Petromec Inc *v* Petroleo Brasileiro SA Petrobas [2006] 1 Lloyd's Rep.121....... **[4.149]**
Petromec Inc *v* Petroleo Brasiliero SA [2007] 1 Lloyd's Rep.629.................. **[1.25]**

Philips Electronique Grand Publique SA *v* British Sky Broadcasting Ltd [1995] EMLR 472 .... **[4.45]**
Photo Production Ltd *v* Securicor Transport Ltd [1980] AC 827 .... **[4.11], [4.14], [4.60], [5.37]**
Piermay Shipping Co. S.A. And Brandt's Ltd. *v* Chester (The Michael) [1979] 2 Lloyd's Rep.1 .... **[2.12], [2.13], [2.41], [3.14], [4.88]**
Pogo Holding Co *v* New York Property Insurance Underwriting Association 467 N.Y. S.2d 872 (1983) .... **[2.23]**
Popi M, The. See Rhesa Shipping Co.S.A v Herbert David Edmunds & Fenton Insurance Co.Ltd
Prudential Inusrance *v* Commissioners of Inland Revenue [1904] 2 KB 658 .... **[2.7], [2.13]**
PT Buana Samudra Pratama *v* Marine Mutual Insurance Association (NZ) Ltd (The Buana Dua) [2011] EWHC 2413 (Comm) .... **[2.38]**
Quinn *v* CC Automotive [2010] EWCA Civ.1412 .... **[1.19]**
Rainy Sky SA *v* Kookmin Bank [2011] UKSC 50 .... **[4.22]**
Re H [1996] AC 563 .... **[3.5]**
Re Hampshire Land [1896] 2 Ch 743 .... **[1.21]**
Re Williams and Thomas and The Lancashire and Yorkshire Co [1902] 19 TLR 82 .... **[5.57]**
Reddaway *v* Banham [1896] AC 199 .... **[1.1]**
Reid & Co. Limited *v* Employers' Accident & Insurance Co. Limited (1899) 1 F 1031 .... **[4.15]**
Rhesa Shipping Co.S.A *v* Herbert David Edmunds & Fenton Insurance Co.Ltd (The Popi M) [1985] 2 Lloyd's Rep.1 .... **[3.7]**
Roberts *v* Avon Insurance Company Ltd [1956] 2 Lloyd's Rep.240 .... **[4.16]**
Robinson *v* Harman (1848) 1 Ex 850 .... **[4.72]**
Rookes *v* Barnard [1964] AC 1129 .... **[4.75]**
Royal Boskalis Westminster NV *v* Mountain [1997] LRLR 523 .... **[2.19], [4.36], [4.115]**
Sanday & Co *v* British & Foreign Marine Insurance Co [1915] 2 KB 781,786 .... **[4.80]**
Scally *v* Southern Health and Social Services Board [1992] 1 AC 294 ..... **[4.51], [4.56]**
Schneider *v* Heath (1813) 3 Camp 506 .... **[1.7]**
Scholoss Bros *v* Stevens [1906] 2 KB 665 .... **[3.8]**
Shah *v* Ul-Haq [2009] EWCA Civ.542 .... **[4.159]**
Sharon's Bakery (Europe) Ltd *v* (1) AXA Insurance UK Plc (2) Aviva Insurance Ltd. [2011] EWHC 210(Comm) .... **[2.36]**
Shell UK Ltd *v* Lostock Garage Ltd [1976] 1 WLR 1187 .... **[4.48]**
Similarly, in Fargnoli *v* G.A. Bonus plc [1997] CLC 653 .... **[4.99]**
Skanska Rasleigh Weatherrfoil Ltd *v* Somerfield Stores [2006] EWCA Civ.173 .... **[4.22]**
Slattery *v* Mance [1962] 1 ALL ER 525 .... **[3.8]**
Smith New Court Securities Ltd *v* Scrimgeour Vickers (Asset Management) Ltd [1997] AC 254 .... **[1.15]**
Smith *v* Chadwick (1844) 9 App.Cas.187 .... **[1.14], [1.26], [1.32]**
Smith *v* Land and House Property Corporation (1894) 28 Ch.D 7 .... **[1.9]**
Society of Lloyd's *v*. Robinson [1999] 1 WLR 756 .... **[4.22]**
Solle *v* Butcher [1950] 1 KB 671 .... **[1.11]**
Spence *v* Crawford [1939] 3 ALL ER 271 .... **[4.128]**
Spice Girls Ltd *v* Aprilia World Service BV [2000] EMLR 478 .... **[1.6]**

Spinneys Ltd *v* Royal Insurance Co Ltd. [1980] 1 Lloyd's Rep.406................. **[3.8]**
Sprung *v* Royal Insurance (UK) Ltd [1999] 1 Lloyd's Rep. IR 111................. **[6.12]**
Standard Chartered Bank *v* Pakistan National Shipping Corp. (No.2) [2000] 1 Lloyd's Rep.218.. **[1.32]**
Star Sea, The. See Manifest Shipping Co Ltd v. Uni-Polaris Insuance Co.Ltd and La Reunion Europeene
Stemson *v* AMP General Insurance (NZ) Ltd [2006] Lloyd's Rep.IR.852.. **[2.19], [2.30]**
Super Chem Products Ltd *v* American Life and General Insurance Co.Ltd. [2004] UKPC 2; [2004] 2 ALL ER 358.. **[4.9]**
The Glamorgoanshire Iron and Coal Company *v* Irvine (1866) 4 F&F 947.........**[1.23]**
The National Exchange Company of Glasgow *v* Drew (1855) 2 Macq 102.........**[1.20]**
Three Rivers District Council *v* Governor and Company of the Bank of England (No.3) [2003] 2 AC 1.. **[3.2]**
Tiep Thi To *v* Australian Associated Motor Insurer Ltd [2001] 161 FLR 61....... **[2.31]**
Transfield Shipping Inc. *v* Mercator Shipping Inc. (The Achilleas) [2009] 1 AC 61.. **[4.74]**
Transthene Packing Co.Ltd *v* Royal Insurance Ltd. [1996] LRLR 32............... **[2.23]**
Trinder, Anderson & Co *v* Thamas & Mersey Marine Insurance Co [1898] 2 QB 114.. **[2.6], [2.7]**
Twinsectra Ltd *v* Yardley [1999] Lloyd's Rep. Bank 438.................. **[1.3], [4.139], [6.5]**
Vaswani *v* Italian Motors (Sales and Services) [1996] 1 WLR 270................. **[4.64]**
Vitol SA *v* Esso Australia Ltd [1989] 2 Lloyd's Rep 451............................ **[6.13]**
Vitol SA *v* Norelf Ltd [1996] AC 800.. **[6.11]**
Wales *v* Wadham [1977] 1 WLR 199.. **[1.10]**
Walters *v* Morgan (1861) 3 D F&G 718.. **[1.6]**
West London Commercial Bank *v* Kitson (1884) 13 QBD 360...................... **[1.11]**
Western Bank of Scotland *v* Addie (1867) LR 1 Sc&Div 145........................ **[1.28]**
Whitehead *v* Hullett (1945) 79 LIL.Rep.410... **[3.8]**
Wisenthal *v* World Auxilliary Insurance Corp Ltd (1930) 38 Ll.L.Rep.54......... **[2.27]**
With *v* O'Flanagan [1936] Ch 575.. **[1.16]**
Wood *v* Associated National Insurance Co Ltd [1985] 1 Qd R 297......... **[2.11], [3.19]**
Yeganeh *v* Zurich Insurance Co [2010] EWHC 1185 (QB); [2011] EWCA Civ.398.. **[2.34], [3.7]**
Youell *v* Bland Welch & Co Ltd [1992] 2 Lloyd's Rep 127................. **[4.28], [6.6]**

TABLE OF STATUTES

Arbitration Act 1996

Section 7 .... [4.11]

Civil Procedure Rules

Rule 31.23 .... [4.92]

Rule 32.14 .... [4.92]

Landlord and Tenant Act 1954 .... [1.11]

Marine Insurance Act 1906

Section 17 .... [4.3], [4.6], [4.13], [4.20],[4.79],[4.80], [4.82], [4.83], [4.84], [4.88], [4.90], [4.91], [4.92], [4.93], [4.100], [4.101], [4.102], [4.104], [4.114], [4.119], [4.131], [4.136], [4.155], [5.2], [5.14], [5.29], [6.3], [6.4], [6.14], [6.15], [6.20]

Section 18 .... [2.19], [4.84], [5.14]

Section 19 .... [4.80], [4.84], [5.14]

Section 20 .... [4.80], [4.84]

(4) .... [1.15]

Section 33

(1) .... [4.40]

(3) .... [4.39], [6.11]

Section 35

(1) .... [4.40]

Section 39

(5) .... [1.20], [2.12], [4.90]

Section 55

(1) .... [2.6], [2.11], [2.12]

(2) .... [2.6],[2.11], [2.12]

Section 61 .... [2.38]

Section 62 .... [2.38]

Misrepresentation Act 1967 .... [1.11]

Section 2 (2) .... [4.155]

Rent Act 1977 .... [1.11]

Third Parties (Rights against Insurers) Act 1930 .... [4.93]

Unfair Contract Terms Act 1977 .... [4.14]

TABLE OF OVERSEAS LEGISLATION

Australian Insurance Contract Act 1984

Section 12.. [2.17]

Section 13.. [2.17]

Section 56 (2)... [2.17]

Australian Marine Insurance Act 1909

Section 61 (2) (a).. [2.11]

ABBREVIATIONS

ALL ER	All England Law Reports
AC	Appeal Cases
App Cas	Appeal Cases
ABI	Association of British Insurers
B&S	Best&Smith's Queen's Bench Reports (1861-1865)
Burr	Burrows' King's Bench Reports (1757-1771)
BCLC	Butterworths Company Law Cases
Camp	Camp Reports
SCR	Canada Supreme Court Law Reports
Ch D	Chancery Division Law Reports (1876-90)
Ch	Chancery Law Reports
Com Cas	Commercial Cases (1896-1941)
CLC	Commercial Law Cases
Cowp	Cowper's King's Bench Reports (1774-1778)
DLR (3rd)	Dominion Law Reports (3rd series)
East	East's Term Reports, King's Bench (1801-1812)
edn	Edition
Ed	Editor
EWCA Civ	England and Wales Court of Appeal Civil Division
EWHC	England and Wales High Court
EMLR	Entertainment and Media Law Reports
Ex	Exchequer Reports (1847-1856)
e.g.	Exempli gratia (Latin) for example
FLR	Family Law Reports
F	Federal Reporter
fn	footnote
F&F	Foster & Finlason's Nisi Prius Reports (18567)

HCA	**High Court of Australia**
HL	**House of Lords**
Ibid	**Ibidem (Latin) in the same place**
IFED	**Insurance Fraud Enforcement Department**
IR	**Irish Reports**
JBL	**Journal of Business Law**
JCL	**Journal of Contract Law**
JIML	**Journal of International Maritime Law**
KB	**King's Bench Law Reports (1901-1952)**
LQR	**Law Quarterly Review**
LR Ch	**Law Reports, Chancery Division (3rd Series)**
LR Sc&Div	**Law Reports, Scotch & Divorce Appeal Cases**
LT	**Law Times Reports**
Ltd	**Limited**
Lloyd's Rep IR/LRLR	**Lloyd's Law Reports Insurance and Reinsurance**
L1L Rep	**Lloyd's List Law Reports (1919-1950)**
Lloyd's Rep	**Lloyd's List Law Reports (1951-)**
LMCLQ	**Lloyd's Maritime and Commercial Law Quarterly**
Macq	**Macqueen's Scotch Appeal Cases**
MIA	**Marine Insurance Act**
M&W	**Meeson&Welsby's Exchequer Reports (1836-1847)**
NYS2d	**New York Supplement, second series**
p	**page**
PC	**Privy Council**
QB	**Queen's Bench Law Reports**
QBD	**Queen's Bench Division Law Reports (1875-1890)**
Qd R	**Queensland Reports**
RBS	**Royal Bank of Scotland**
SA	**South African Law Reports**

SASR	**South Australia State Reports**
TLR	**Times Law Reports**
WLR	**Weekly Law Reports**

ACKNOWLEDGEMENTS

I have to admit that writing a PhD thesis is indeed a tiring, stressful and annoying journey. I tried, failed; I tried again, failed again but I failed better and finally I succeeded. I loved every moment of this journey because I have gained strength, courage and confidence by every experience in it.

Along the journey, I have incurred a great deal of debts of gratitude during the past few years. I owe particular thanks to my supervisor, Professor Baris Soyer, who not only cultivated and nailed my interest in marine insurance law and insurance industry in the first place through his marvelous lectures and seminars in my LLM stage, but also patiently and accurately provided many useful comments and insights to my PhD thesis. I greatly enjoyed all of our discussions and debates in the supervision meetings and his guidance is sincerely appreciated. I am thankful to Professors Richard Williams, Rhidian Thomas and Dr. Richard Caddell for their valuable suggestions on several occasions during the writing of the thesis. I am also grateful to Ms Helen Summer and Mrs. April Adanah who were always around whenever I needed the administrative support.

I am indebted to the School of Law of Swansea University for the part-time teaching position and financial support given in the last four years. These not only enabled me to overcome my financial difficulties but also gave me the first-hand academic and teaching experience which I believe will be very helpful to my future career. I would also like to acknowledge the debt that I owe to the students I taught over the years. Many of them not only greatly assisted the understanding of my subject, but also became my life-time friends.

In addition, I was honored and greatly grateful to be appointed as the research assistant of the Institute of International Shipping and Trade Law, which not only enabled me to have the unlimited access to the fabulous library of the Institute, but also provided the opportunities to me to attend the numerous academic events held by the Institute, which greatly deepened my understanding of the law, the shipping and insurance industry.

I truly owe a lot to Yuxia who has been extremely supportive and patient in so many ways during my countless hard times in writing this work. Without her wholehearted love, this work would not have been possible.

Finally, I am above all deeply and especially grateful to my parents for their endless love, support, encouragement and understanding, without which no single achievement in my life would have been possible.

INTRODUCTION

I. OUTLINE AND OBJECTIVES

In William Shakespeare's ultimate tragedy *Othello* Act III Scene III, when Othello was tempted by the villain Iago's lie to falsely believe that his lovely wife Desdemona was disloyal to him, he asked Iago to provide the proof bearing no hinge nor loop otherwise he would make him suffer. The heinous Iago feignedly complained that:

> "O monstrous world! Take note, take note, O world! To be direct and honest is not safe...I should be wise; for honesty's a fool, and loses that it works for."[1]

The context may be different, but "what a fool Honesty is"[2] has become the commonly cited justification for the greediness of human beings. Dishonesty, deceit and fraud, have always existed in society and particularly in commercial context. The law, as a social control mechanism, has always stood up against dishonesty. Tracing back to Roman times, where a deceitful statement induced an innocent party to enter into a disadvantageous contract, the law had been equipped the basic provisions to deal with this situation[3]. With the development of the society, fraud has evolved as well, becoming more and more imaginative, complicated and pernicious.

Among all kinds of fraud in the private sector, insurance fraud is in particular a very big business, the cost of which is immense and possibly out of the imagination of ordinary people. According to UK's Insurance Fraud Bureau (IFB) and the Association of British Insurers (ABI), generally speaking (including both commercial and consumer insurance), around £1.6 billion of fraudulent insurance claims are made in 2009 but the figure rose to £2 billion in 2010. Also in 2010, 2,500 fraudulent insurance claims were uncovered every week. Statistics show that the number and overall value of detected insurance fraud has increased by 100% overall in the last

[1] William Shakespeare, *Othello*, 3.3.381-384

[2] William Shakespeare, *Winter's Tale*, 4.4.597

[3] See Ulph, J, *Commercial Fraud*, Oxford (2006), 1.01

five years.[4] It seems that in tough economic times, some people see insurance as a mechanism of making easy money.

Furthermore, insurance fraud does not live on an isolated island; it has infiltrated into every honest insurance buyer's life by causing the increase in the amount of premium paid. As it is correctly pointed out that "the apparently widely held view that fraud is a victimless crime as it is the insurers who pays and they can well afford to, is erroneous."[5] This aspect of insurance fraud becomes more transparent if the economic dynamics behind insurance transactions are considered.

In all commercial activities there is an element of risk, and to live and labor in risk is the common topic of all business men. In a general sense, there is a similarity between business men and risk adverse people, in the sense that they will both try either to eliminate or diminish or to average their risks. In other words, they will always aim at minimizing their chances of loss[6]. Insurance is such a social device demanded by business men and designed to meet the needs of them. It makes accumulations to meet uncertain loss through the transfer of the risks of many individuals to one person or to a group of persons (insurers).[7] Business men choose to give up a certain amount of income (usually called premium) to avoid having to face uncertain outcomes and insurers bear the risk of the uncertain event. The risk-averse business men consider themselves better off by giving up the lower certain income than facing the uncertain higher loss.

---

[4] "*No hiding place for cheats as drive to reduce insurance fraud moves to a gear*", ABI News Release, 05 July 2011, available at www.abi.org.uk, accessed on 3rd April 2012

[5] Thoyts, R, *Insurance Theory and Practice*, Routledge (2011), 207

[6] Risk could be defined as the chance of loss and two things are implied in this definition: first, uncertainty as to the outcome of some future event or events; second, loss as the result of at least one possible outcome. Mowbray, AH, *Insurance*, 3rd edn, McGraw-Hill Book Company (1946), 2

[7] Willett, AH, *The Economic Theory of Risk and Insurance*, University Press of the Pacific Honolulu (1901), 106: "wherever there is accumulation for uncertain losses, or wherever there is a transfer of risk, there is one element of insurance; only where these are joined with the combination of risks in a group is the insurance complete."

The fact that insurers, as professional risk bearers, are willing to bear to risk is not because they prefer uncertainties or they are risk-seeking or risk-preferring people but because they may be able to apply the law of large numbers to reduce or even eliminate the risk transferred to them, and then make the profit by collecting the premiums. The profit that the insurers can get, to a large extent, is determined by successful prediction of the risks involved, as Professor Clarke neatly pointed out that: "to market the insurance successfully, insurers need to know the extent of the risk proposed, in order to decide whether to take the risk at all and, if so, what premium to charge and what conditions to impose."[8]

Theoretically, if the risk of every individual insured is predictable, the insurers can accordingly offer the appropriate premium rate. However, it is prohibitively expensive to rate every individual risk correctly. In such cases, the insurers may choose to aggregate all the insureds with similar risks to a risk group and charge the same premium to all the individuals in the group, on the basis of the general knowledge of the average losses caused by risks of the type considered. The more precise the classification of the insureds with similar risk is, the less chance that the low risk insureds will be charged with more premiums. The reasonable classification means that insurers must possess all the information of insureds but as a matter of fact, due to the informational asymmetry, it is difficult for the insurers to establish such theoretical risk groups. Sometimes, insurers may have difficulty in distinguishing between high risks insureds[9] and low risks insureds, so insurers have to establish the risk pool on the average loss probabilities and offer them the same premium. Through this process, the low risk insureds are charged with more premiums than they are supposed to be charged,[10] and statistics from ABI revealed that on average every UK

[8] Clarke,M, *Policies and Perceptions of Insurance Law in the Twenty-First Century*, Oxford (2005), 48

[9] High risk insureds are those who are more likely to have accidents or more costly to the insurers, e.g. by cheating the insurers.

[10] Another negative impact of this process is that an insurer may happen to offer the insurance to too many high risk insureds and, therefore, may be economically jeopardized. See Zewifel, P& Eisen,R, *Insurance Economics*, Springer(2012), 291

policy holder has to bear extra £44 due to the consequence of insurance fraud.[11] The following quoted passage from a research report of ABI, explicit in statistics, vividly explains the point in a compendious way: [12]

> "The majority of fraudulent claims arise from the exaggeration of genuine incidents...other ways of committing fraud include inventing a claim or providing false information on an application for insurance. 6% of companies are aware of instances of withholding or providing false information on an application. However, this figure rises to 40% of the largest companies. The most costly frauds are those which are either entirely bogus or staged. Invented or staged claims are relatively low in volume, but higher in cost, because the costs of the claims are generally higher. Whatever the type of fraud, the cost ultimately falls on businesses in the form of higher premiums."

In brief, insurance fraud is perhaps one of the most pressing problems challenging the insurance industry.[13] Fraudulent claims account for a significant portion of all claims received by insurers, and cost billions annually. Types of insurance fraud are very diverse, and occur in all areas of insurance. Insurance fraud also ranges in severity, from slightly exaggerating claims to deliberately causing accidents or damage. Fraudulent activities also affect the lives of innocent people, both directly through accidental or purposeful injury or damage, and indirectly as fraud causes insurance premiums to be higher. Insurance fraud poses a very significant problem and, therefore, it is one of the priorities of the relevant organizations, governmental or non-governmental, to investigate it, deter it and punish it, which also makes it a topic deserving careful and considerable academic research.

---

[11] "*No hiding place for cheats as drive to reduce insurance fraud moves to a gear*", ABI News Release, 05 July 2011, available at www.abi.org.uk, accessed on 3rd April 2012

[12] ABI, *UK commercial Insurance Fraud Study 2005* A summary of a research report prepared by MORI for the Commercial Insurance Fraud Steering Group (2005)

[13] In 2004, a leading insurance journal held its fifth annual conference on fraud: "Fighting the Battles. Winning the War". Insurance Companies are appointing "anti-fraud teams" and insurance fraud had become a subject for serious study. See Clarke,M, *Policies and Perceptions of Insurance Law in the Twenty-First Century*, Oxford (2005), 200

The judiciary plays a significant role in tackling insurance fraud: the burden is on their shoulders to identify the appropriate legal rules governing fraudulent claims and determining the consequences of fraud. However, regrettably, this process has long remained elusive and in the recent decades the courts have tried but failed to formulate clear principles for the treatment of insurance fraud, so the process is, still, continuing. This judicial process is not free from difficulty particularly with regard to the consequence of presenting fraudulent claims, as Lord Justice Aikens viewed that "if the law stays as it is...the consequence will remain opaque...and logically irreconcilable.[14]

The failure of judicial attempts to formulate clear principles in this jurisdiction has attracted the attention of the Law Commissions which intend to pursue a reform at the legislative level in the hope of making the law fair, modern, simple and as cost-effective as possible. Reforming the fraudulent claims jurisdiction has, therefore, been included into the Law Commissions' project of reforming insurance contract law. Just at the end of 2011, a consultation paper covering this issue has been released and consultation has been invited.

At the current stage, the practice of fraud in insurance on the part of insureds seems common and serious, and the law seems to stand at a turning point and try to adapt itself to the new situation. Just as the blacksmith can shape iron only by striking it with his hammer when it is red hot, the author is of the opinion that this is the right time to provide a full-scale research in the jurisdiction of insurance fraudulent claims for the purpose of shaping the appropriate legal regime and contributing to the evolving reform process of English insurance contract law.

It should be noted the focus of this thesis is on the commercial insurance law only. The difference between commercial insurance law and consumer insurance law

[14] Aikens, *The post-contract duty of good faith in insurance contracts: is there a problem that needs a solution?* [2010] JBL 379, 392

probably derives from the distinctions between commercial contract law and consumer contract law.[15] Put compendiously, commercial contract law insists that the contractors should be held to their freely agreed exchange, whereas consumer contract law intends to make sure that consumer contractors can enter into a fair deal and relieve against the harsh or unconscionable bargain.[16] The reflection of this contrast in insurance contract law is that consumer insurance law has now its own special jurisdiction, namely Financial Ombudsman Service (FOS) jurisdiction,[17] and special legislation, e.g. The Consumer Insurance (Disclosure and Representations) Act 2012.[18] Those special treatments will not be evaluated in this thesis. The discussion of this thesis is established on the premise that the parties to the insurance contract are not inexperienced consumer, but well able to negotiate their own contracts.[19]

Furthermore, the author is of the opinion that considering the viability of reform proposals from a novel perspective, namely economics and law, might add a very interesting dimension to the debate. It is believed that the law and economics debate would be helpful in explaining the outcomes of certain legal solutions and identifying the most appropriate legal remedy.

---

[15] Brownsword, R, *Contract Law: Themes for the Twenty-First Century*, 2nd edn, Oxford (2006), 138: "If we treat the modern law of contract as having two principal divisions, one regulating commercial contracts and the other regulating consumer contracts…"

[16] *Ibid.*, 137

[17] In *R (on application of Heather Moor& Edgecomb) v Financial Ombudsman Service* [2008] EWCA Civ.642, Lord Justice Rix observed that: "For some years the insurance ombudsman (now within the FOS scheme) has been developing a new common law of insurance for consumer contracts, without which the courts would have been constrained to find, or alternatively to reject, solutions to problems from which they have been in the main shielded." See, generally, Summer, JP, *Insurance Law and The Financial Ombudsman Service*, Lloyd's List (2011)

[18] The Act just received Royal Assent on 8th March 2012, and it is hoped that it will come into force in a year's time.

[19] *Eagel Star Insurance Co Ltd v Cresswell & Others* [2004] EWCA Civ.602, [54] (Rix LJ). This premise is particularly important in relation to the discussion of fraudulent claims clause, implied terms regulating fraudulent claims and their economic justification.

In conclusion, the principal aims of this thesis can be summarized as follows:

(1) To review the current law in respect of fraudulent claims in commercial insurance. Identifying the existing difficulties and confusions in this area, and to provide a tentative reform proposal towards the resolution of such difficulties and confusions;

(2) To scrutiny this preliminary proposal in an interdisciplinary economic context;

(3) The author also wants to discuss to what extent the solutions suggested by him will be compatible with the economic analysis carried out, and to what extent the Law Commissions' proposal could be defended in the light of previous legal and economic analysis.

II. METHODOLOGICAL ISSUES

A. The Study of Case Law

Due to the existence of the doctrine of precedent, the study of any branch of English law inevitably involves to a very great extent the study of case laws. Although Marine Insurance Act 1906 functions as a leading source of both marine insurance and non-marine insurance law, it must be viewed with caution for at least two reasons:[20] (1) it merely is a codification of the judicial decisions in 18th and 19th centuries, which cannot stand alone and must be considered together with the post-1906 judicial decisions; and (2) it is not fully exhaustive, so the analysis should not be confined to it. As a matter of fact, most of the fraudulent claims issues that will be discussed in the thesis fall outside the scope of the Marine Insurance Act 1906.

The objective of the thesis is to try to collect the judicial authorities in relation to the concept of fraudulent insurance claims as comprehensively as possible. To achieve this purpose, it is noteworthy that the study of case laws in this thesis is not limited to insurance cases, as was stated by Professor Clarke: "Neither insurance nor insurance

[20] Merkin, R, *Marine Insurance Legislation*, 4th edn, LLP (2010), 2

law functions or develops in isolation."[21] Fraud, in essence, is behaviour, and behaviour has been a traditional concern of tort law. Therefore, some case studies will focus on tort law, particularly the tort of deceit. In addition, the relationship between insurer and insured is mainly regulated by contract and accordingly, the relevant contract law cases and their application in insurance context will be considered. Last but not least, due to the fact that most of the insurers and insureds in commercial context are organized as legal entities, some company law cases and agency cases will, therefore, be analyzed in the certain parts of the thesis.

Insurance law is not only a national business but also has a global dimension. On the one hand, the Marine Insurance Act 1906 received international recognition,[22] but it is not ignorable that other common law jurisdictions have also been influential to English law, and to a certain extent, English law should not resist those influences, as Professor Brownsword said: "English Law might be special; but parochialism is no longer acceptable…where English law is out of line with the position in other common law jurisdiction, this places a question mark against the defensibility of the English view."[23] Therefore, for the purpose of grasping a full view of the relevant problems and filling the gaps of English law, some cases with persuasive reasonings from other common law jurisdictions, e.g. Australia, will be carefully and extensively evaluated despite that they do not form a part of judicial precedent in English jurisdiction. It is clearly imprinted in the author's mind that: "no study deserves the name of a science if it limits itself to phenomena arising within its national boundaries."[24]

B. Jurisprudential Analysis

As it has been stated above, the ultimate purpose of the thesis is to propose an appropriate reform scheme of the law in relation to insurance fraudulent claims. This

[21] Clarke, M, *Policies and Perceptions of Insurance Law in the Twenty-First Century*, Oxford (2005), 352

[22] Merkin, R, *Marine Insurance Legislation*, 4th edn, LLP (2010), 3-4

[23] Brownsword, R, *Contract Law: themes for the twenty-first century*, 2nd edn, Oxford (2006), 138

[24] Zweigert, K&Kotz, H *Introduction to Comparative Law*, 3rd edn, Oxford(1998), 3

reform scheme should not only be established by examining the current legal rules, but also be tested by certain legal values and spirits. In other words, the social, moral and cultural foundations of the reform scheme must be taken into account. To achieve this purpose, some issues will be discussed from a jurisprudential point of view. Certain legal theories will be introduced in the relevant part of the thesis. In the view of the author, theoretically, the reform proposal should be able to carry the following values: (1) it must be certain; (2) it must be readily ascertainable, so the parties of insurance contracts know what are their rights and obligations; (3) it must be just and practically enforceable.[25]

C. Economic Analysis

One of the objectives of the thesis is to evaluate how the law could be reformed. Any debate on law reform must intend to consider what social values that reform must promote if implemented. From perspective of economics, one of those significant values is "efficiency". "Efficiency" is an essential concept of the subject of microeconomic and is regarded as a basic tool approaching the economic analysis of law.[26] Basically, it means the given policy should be achieved at lower cost than at higher cost. Thus, in order to find out their justification in economic context, certain conclusions from the part of legal analysis will be further examined by using the concepts of "efficiency" and other related concepts in microeconomic such as "cost" and "utility".

In addition, it is observed that one of the factors contributing most to fraudulent claims is the asymmetric information accompanied with moral hazard problem existing in the insurance market.[27] From the perspective of economics, the subject of

---

[25] See generally, Bingham,T, *The Rule of Law*, Allen & Lane (2010), Chapter 3; Denning, *The Changing Law*, Stevens & Sons (1953), 8

[26] See generally, Mercuro, N& Medema, SG, *Economics and Law: From Posner to Post-modernism*, Princeton University Press (1997), Chapter 1

[27] In 1963, a remarkable economist Kenneth J Arrow has already pointed out that the asymmetric information problem between the insured and underwriter is the main obstacle to the development of the insurance industry. See Arrow, *Uncertainty and the Welfare Economics of Medical Care, American Economic Review* 53 (5): 941–973.

game theory is considered as a leading analytic tool towards the problems of asymmetric information.[28] Therefore, some basic concepts in game theory, such as "strategy" and "incentives", will be used as a supplementary tool to the microeconomic analysis.

It is anticipated that the economic analysis could contribute to the discussions in two respects. First of all, economic research could provide independent tests on whether the conclusions reached in legal analysis could be justified in the eyes of economics. It should always need to be borne in mind that a good law need not only be fair, modern and simple, but also be as cost-effective as possible. Secondly, any conclusions reached by economic research could reinforce the strength of arguments proposed by the author in the legal analysis. In short, economic analysis conducted in the thesis would function as a safeguard mechanism in double-examining or double-evaluating the conclusions proposed in the legal analysis, for the purpose of making the conclusions as persuasive as possible

III. STRUCTURE OF THE THESIS

The thesis intends not only to provide a full-range of legal analysis on fraudulent claims in the current commercial insurance law, but also to accurately point out the flaws of the current system and provide the corresponding reform solution to them. In addition, as a novel point of the thesis, an interdisciplinary research, namely economic research, will be conducted to evaluate all the conclusions made in the part of legal analysis. The research conducted by the author is independent of the research conducted by the Law Commissions but the author will also give a detailed analysis on Law Commissions' proposal for the purpose of finding out whether the two proposals are compatible, and if not, which one would be better.

In order to achieve the aforesaid purposes, the structure of the thesis will be arranged as follows: it will be divided into three parts with six main chapters and one short concluding chapter.

[28] Professor Joseph E. Siglitz, who won the Nobel Prize in 2001, using the insurance industry as a background, has contributed greatly to the research on asymmetric information theories.

Part I of the thesis, consisting of four chapters, intends to outline and evaluate the current legal position in relation to fraudulent claims. A wide range of issues, from substantive law to procedure law, will be fully discussed. Chapter One intends to identify the meaning of fraud in law and more specifically in insurance law. Two main elements of fraud will be discussed: (1) the statement made should be false (objective element); and (2) the person who makes the statement should know the falsity of the statement and should have the intention to cheat(subjective element). The analysis will reveal that fraud is a developing concept and the types of fraud in insurance are not limited to the ones clearly identified in the thesis.

Chapter Two analyzes five main types of insurance fraudulent claims as defined by the English courts, namely (1) wilful fabrication of claims; (2) exaggeration claims; (3) the use of fraudulent means or devices to support an otherwise legitimate claim; (4) fraudulent suppression of insurers' defence; (5) fraudulently maintaining an initial clean claim. The characteristic and the constituting requirements of each type will be identified and fully explored in the light of abundant case law.

Chapter Three provides discussion on the issues of burden of proof and standard of proof in fraudulent claims cases. In addition, by using the various authorities, this chapter will also discuss the prospects of detecting and discovering the fraudulent claims by so-called "fraud indicators".

Chapter Four is the main body of the black-letter research part of the thesis. It focuses on the potential remedies available when a fraudulent claim is presented. Four possible consequences of making fraudulent claims, namely (1) common law of forfeiture; (2) breach of fraudulent claims clause; (3) breach of implied term governing fraudulent claims; (4) breach of Section 17 of Marine Insurance Act 1906, will be reviewed and the perplexity of the current jurisdiction will be identified and criticized. This chapter intends to reveal that the law in this regard has yet to be settled, and at the end of this chapter, a restatement of law or reform suggestion will be tentatively proposed.

Part II of the thesis consists of one chapter (Chapter Five). It is devoted to economic analysis of fraudulent claims. The introduction part of this chapter intends to justify the use of economic analysis on this particular subject and the main body intends to provide a two-dimensional evaluation on this subject: (1) to test whether the proposal raised in the legal research can be justified from the perspective of economics, namely, whether the proposal is "efficient"; and (2) it is suggested that, from a point of view of economics, some clauses (other than fraudulent claim clauses discussed in Chapter Four) in the insurance contract could function as preventive measures against fraudulent claims, so the economic implications of those clause will be analyzed with a view to suggesting an improvement in their styles.

Part III of the thesis consists of one chapter (Chapter Six) and a concluding chapter. Chapter Six intends to examine the Law Commissions' consultation paper in the hope of achieving two purposes: (1) to see whether the Law Commissions' proposal is both theoretically feasible and practically implementable; and (2) to see whether Law Commissions' proposal is in line with the legal and economic analysis conducted by the author in the previous chapters of the thesis.

At the concluding chapter, it is intended to set out parameters as to how the law can be reformed.

The intention has been to state the law as it stands at 31th July 2012.

CHAPTER ONE

THE DEFITION OF FRAUD IN GENERAL

It is as easy as lying

——William Shakespeare, *Hamlet* 3.2.359

Introduction

[1.1] Lord Macnaghten once used a poetic passage to characterize fraud: "Fraud is infinite in variety; sometimes it is audacious and unblushing; sometimes it pays a sort of homage to virtue, and then it is modest and retiring; it would be honesty if it could only afford it."[29] As beautiful as the description could be, the fraud itself in essence is always ugly and, therefore, "fraud is fraud all the same; and it is the fraud, not the manner of it, which calls for the interposition of the court."[30]

[1.2] The inevitable starting point for any legal discussion in fraud is the decision of the House of Lords in *Derry v Peek.*[31] For instance, in a very recent case of *Aviva Insurance Ltd v Brown,*[32] the insured was accused of using fraudulent means and devices to obtain payment for a genuine loss. The meaning of fraud set out in *Derry v Peek* was the basis of the learned judge's analysis.[33] In *Derry v Peek*, the defendants were directors of a tramways company. The company ran the horse-drawn trams but it obtained a statutory power to run trams by mechanical or steam power if the consent of the Board of Trade was obtained. The directors believed that the Board would give

[29] *Reddaway v Banham* [1896] AC 199, 212

[30] *Ibid.*

[31] (1899) 14 App Cas 337

[32] [2011] EWHC 362 (QB)

[33] The detailed analysis of this case could be found in Chapter Two, at [2.37]

this consent in due course mainly because the Board did not make any objections when the company submitted the plan of using steam power. Accordingly, the directors issued a prospectus stating that the company had the right to the use of mechanical or steam power and the plaintiff subscribed the shares of the company on the faith of this representation. However, the Board of Trade ultimately refused to give its consent and the company was wound up. The plaintiff brought an action in deceit against the directors. The trial judge found against the plaintiff,[34] his Lordship concluded that the directors did believe that they had the right stated in the prospect and the belief was not so unreasonable and so unfound. His Lordship commented that "mercantile men dealing with matters of business would be the first to cry out if I extended the notion of deceit into what is honestly done in the belief that these things would come about, and when they did not come about make them liable in an action of fraud".[35] However, the Court of Appeal reversed the trial judge's decision on the basis that "a man who makes a representation with the view of its being acted upon, in the honest belief that it is true, commits a fraud in the eye of the law, if the court or a jury shall be of opinion that he had not reasonable grounds for his belief".[36] The essence of the Court of Appeal's judgement was that "in an action for 'deceit' it would be necessary to submit to the jury (if tried before that tribunal) not only the existence of that belief bona fide, but also the grounds on which it was arrived at, and their reasonableness."[37] The House of Lords, constituted by a panel of "great common lawyers",[38] reversed the decision of the Court of Appeal, on the basis that an action in deceit requires actual fraud, which could not be satisfied merely by the absence of a reasonable basis for the erroneous belief. In other words, the essence should be the absence of an honest belief in the truth of representations; a false representation on insufficient grounds but honestly believed could not be regarded as fraud. In the present case, as the defendants honestly believed what they stated was a fair

---

[34] (1888) 37 Ch.D.541

[35] *Ibid.*, 558

[36] (1899) 14 App Cas 337, 345 (Lord Watson)

[37] (1899) 14 App Cas 337, 358 (Lord Fitzgerald)

[38] *Nocton v Lord Ashburton* [1914] AC 932, 951 (Viscount Haldane, LC): *Derry v Peek* was heard by a panel of Lord Halsbury LC, Lord Watson, Lord Bramwell, Lord Fitzgerald and Lord Herschell.

representation of the facts, the plaintiff's action failed. Lord Herschell explained the essential ingredients of fraud resulting in civil liability as follows:[39]

> "First, in order to sustain an action of deceit, there must be proof of fraud, and nothing short of that will suffice. Secondly, fraud is proved when it is shown that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false. Although I have treated the second and third as distinct cases, I think the third is but an instance of the second, for one who makes a statement under such circumstances can have no real belief in the truth of what he states. To prevent a false statement being fraudulent, there must, I think, always be an honest belief in its truth. And this probably covers the whole ground, for one who knowingly alleges that which is false, has obviously no such honest belief. Thirdly, if fraud be proved, the motive of the person guilty of it is immaterial. It matters not that there was no intention to cheat or injure the person to whom the statement was made. "

[1.3] The cardinal ideas of this speech can be refined to three points which will be elaborated as follows in order to fully understand the meaning of fraud in civil law: (1) The representation should be false or dishonest; (2) The representor should have knowledge of the falsity of the representation; (3) The representor should have a fraudulent intention. These three points can be actually categorized as the objective element of the fraud (the first point) and the subjective element of the fraud (the second and the third points).

This combined objective/subjective dual elements of proving the fraud was abundantly applied in an insurance case mentioned above of *Aviva Insurance Ltd v Brown*,[40] where the insurer alleged that the insured had made fraudulent claims on his insurance policy. The insurer raised many specific allegations against the insured. The learned judge carried out a careful analysis on each allegation made not only as to the

[39] (1899) 14 App Cas 337, 374

[40] [2011] EWHC 362 (QB). As a matter of fact, this combined test was first approved by House of Lords in the case of *Twinsectra Ltd v Yardley* [2002] UKHL 12, where Lord Hutton confirmed that in order to prove dishonesty, it must be established not only that "the defendant's conduct was dishonest by the ordinary standards of reasonable and honest people" but also "that he himself realized that by those standards his conduct was dishonest." See Shine, P, *Dishonesty in civil commercial claims: a state of mind or a course of conduct* [2012] JBL 29

representations made by insured but also as to the insured's state of mind, and his Lordship concluded that some of the allegations were bound to fail because the defendant insured did not believe that he was acting fraudulently.[41]

Therefore, the following discussions on the definition of fraud will be developed on two aspects respectively: (1) the objective element that the representation shall be false will be subject to detailed examination; and (2) the subjective element that the representor shall know the falsity of the representation and shall intend to deceive the representee will be analyzed at length. It shall always be borne in mind that in order to establish the liability both elements must be indispensably proved.

I. The Falsity of the Representation

[1.4] It was stated by Rix LJ in *The Kriti Palm*[42] that the ground of the claim in fraud is "the representation in question" and "its falsity, and the honesty of the representor, cannot begin to be considered until the representation in question has been identified".[43] In addition, his Lordship held in the same case that "in any case of fraud the dishonest representation must be clearly identified".[44] Therefore, two questions shall be solved for the purpose of understanding the ingredients of fraud in the first place: (1) what constitutes representation; and (2) what does it mean by the falsity of representation?

A. The meaning of representation

[1.5] A representation is defined as a "statement made by, or on behalf of, a person (the representor) to, or with the intention that it shall come to the notice of, another person (the representee) which relates, by way of affirmation, denial, description or

[41] The detailed analysis of this case could be found in Chapter Two, at [2.37]

[42] *AIC Ltd v ITS Testing Services (UK) Ltd (The Kriti Palm)* [2007] 1 Lloyd's Rep.555

[43] *Ibid.* [252]

[44] *Ibid.* [254]

otherwise to a matter of fact."[45] It usually takes the form of a written or an oral communication, and the way of its identification was summarized by Rix LJ: [46]

> "In the case of a written document, the representation can usually be pinpointed (unless questions of implication arise), but of course context remains everything. In the case of an oral representation, the identification may be a more difficult process, involving disputed testimony, but again context remains everything."

[1.6] A representation can also be made by positive conduct, as Lord Campbell vividly stated in the case of *Walters v Morgan*[47] that "a nod or a wink, or a shake of the head, or a simple smile from the purchaser intended to induce the vendor to believe the existence of a non-existing fact, which might influence the price of the subject to be sold" would be a sufficient ground for refusing to enforce a contract. In a typical case of *Spice Girls Ltd v Aprilia World Service BV*,[48] SG, a company formed to promote a band named Spice Girls, sought payment of various fees pursuant to a sponsorship agreement with AWS. However, AWS claimed that it was induced into signing the contract by a film and the provision of photographic images including all five members of the band which implied that none of the member had an existing declared intention to leave the group before it was shown but in fact one member of the band had expressed the intention to leave. AWS contended that it had considered that continuity of band membership as essential to the success of its subsequent advertising campaign. The court delivered the judgement in favour of AWS, saying that participation in the commercial shoot had carried with it a representation by conduct that the group would remain intact, so SG had breached its duty of correcting that representation if it was falsified before the AWS entered into the agreement.

---

[45] Handley, *Spencer Bower, Turner and Handley on Actionable Misrepresentation*, 4th edn, Butterworths (2000), 4

[46] *AIC Ltd v ITS Testing Services (UK) Ltd (The Kriti Palm)* [2007] 1 Lloyd's Rep.555, [252]

[47] (1861) 3 D F&G 718, 723-724

[48] [2000] EMLR 478

[1.7] In addition, depending upon the particular context, the withholding of the information may in certain circumstances constitute fraud.[49] That is to say, representation may include the situation where the defendant takes positive steps to conceal the relevant situations. For example, in *Schneider v Heath*,[50] the plaintiff purchased the vessel but during the examination afterwards it was found that the bottom of the ship was worm-eaten and the keel broken. The plaintiff brought the proceedings against the vendor on the ground that he had been induced to enter into the contract by the fraud on the part of the vendor. The Court gave the judgement in favour of the plaintiff and said that: "it appears that means were taken fraudulently to conceal the defect in the ship's bottom" [51] because the captain removed the vessel from a dry dock and kept her afloat until the sale was over. Similarly, in *Gordon v Selico Ltd*,[52] the deliberate concealment of the dry rot condition in a flat before letting it to the claimant was held to be a knowingly misrepresentation for the purpose of giving rise to the liability of deceit. However, mere silence, for instance, where the defendant knowingly stood by and allowed the claimant to persist in his misunderstanding,[53] will not be sufficient for the action of fraud. Ultimately, the question is to ascertain whether the person, by his words or actions, has misled the other.[54]

[1.8] It is submitted that the first step of proving fraud is that "the claimant must prove that the defendant has made a clear representation of present fact."[55] Accordingly, if a fact is misrepresented, the representor will be exposed to a charge of fraud if that fact is known by the representor to be false. Traditionally, it was often said that in order to be actionable, a misrepresentation must have been one of the

---

[49] *Aviva Insurance Ltd v Brown* [2011] EWHC 362 (QB), [64]

[50] (1813) 3 Camp 506

[51] *Ibid.*, 509

[52] (1986) 18 H.L.R. 219

[53] *Peek v Gurney* (1873) LR 6 HL 377, 390-391

[54] Beatson, J & Burrows, A & Cartwright, J, *Anson's Law of Contract*, 29th edn, Oxford (2010), 302

[55] *Crystal Palace FC (2000) Ltd v Dowie* [2007] EWHC 1392 (QB), [18] (Tugendhat J)

"fact", in contrast to "opinion", "intention" and "law".[56] However, with the development of the law, the importance of this distinction has faded away, or has been qualified to a certain extent, particularly in relation to fraudulent misrepresentation.

[1.9] First of all, although it was stated in *Smith v Land and House Property Corporation*[57] that "it is often fallaciously assumed that the statement of an opinion cannot involve the statement of fact", [58] the true position might be different. In this case, the vendor described the tenant of property sold as "a most desirable tenant" which was not true because the tenant's financial position was very poor. It was argued by the vendor that his statement had been no more than an expression of opinion but this argument was rejected by Bowen LJ, who said that "if the facts are not equally well known to both sides, then a statement of opinion by one who knows the facts best involves very often a statement of a material fact, for he impliedly states that he knows facts which justify the opinion." [59]

However, if the representor is in no better position than the representee to know the facts, a statement of opinion will not be qualified as a statement of fact. In *Bisset v Wilkinson*,[60] Wilkinson would like to purchase a land for the purpose of sheep-farming. Bisset told Wilkinson that in his opinion, if properly worked, the land would support 2,000 sheep. However, Wilkinson knew that Bisset had not worked the land himself as a sheep farmer, so the statement was merely an estimate made without particular knowledge or expertise and thus was not capable of constituting the representation for the purpose of proving the fraud.

It may, therefore, be concluded that the crucial factor of deciding whether a statement of opinion could be regarded as a statement of fact is whether the knowledge of the parties are balanced. The position could be supported by an

---

[56] Peel, E, (Ed), *Treitel, The Law of Contract*, 13th edn, Sweet&Maxwell (2011), 9-003 to 9-013; *Chitty on Contracts*, 30th edn, Sweet&Maxwell (2008), 6-006

[57] *Smith v Land and House Property Corporation* (1894) 28 Ch.D 7

[58] *Ibid.*, 15

[59] *Ibid.*

[60] [1927] AC 177

insurance case of *Economides v Commercial Union Assurance Co.plc*, [61] where the court held that there was no misrepresentation when a son incorrectly stated the value of his parents' belongings for the purpose of a contents insurance policy. They were not his belongings so that he was not in any better position than the insurers to know their true values. Although this is a pre-contractual misrepresentation case, the underlying principle could be similarly applied at the claim stage: if a son incorrectly stated the value of his parents' belongings for the purpose of making the claim, it is probable that the situation would not be qualified as an exaggeration of claim.[62]

The judgements of the above two cases were established on the basis that one party did not possess more knowledge than the other party, nor did he owe the duty to carry out the inquiries in order to verify the basis of his opinion. The position would be, however, otherwise if one party possesses special knowledge or expertise with regard to subject matter of his statement of opinion in question. In *Esso Petroleum co Ltd v Mardon*,[63] Mr Mardon, as a potential tenant of the petrol station built by Esso, entered into the tenancy agreement with Esso mainly on the ground that one of Esso's employees Mr Leith who had forty years' experience in the petrol trade made the estimation that throughput of the station was 200,000 gallons per year. However, this forecast turned out to be inaccurate and Mr Mardon suffered the loss accordingly. Lord Denning MR, with whom Shaw LJ and Ormrod LJ agreed, held that the statement of opinion by Mr Leith was capable of forming the statement of fact because he had or professed to have special knowledge or skill, and made a representation-advice, information or opinion-by virtue thereof to Mr Mardon with the intention of inducing him to enter into a contract and therefore, he was under the duty of use reasonable case to make sure that the representation was correct.

[1.10] Secondly, the statement of the present intention may be sufficient to give rise to the liability for fraud when the representor does not in fact have any such intention as he intends to break it, or he knows it cannot be performed. In the case of *Edgington*

[61] [1997] 3 WLR 1066

[62] See Chapter Two, at [2.14]-[2.25]

[63] [1976] QB 801

v Fitzmaurice,[64] a prospectus was held to be deceptive when it said that the money of investors was wanted to further investment in the business but in fact it was needed to pay off existing debts. Bowen LJ commented that: [65]

> "The statement of a man's mind is as much a fact as the state of his digestion. It is true that it is very difficult to prove what the state of a man's mind at a particular time is, but if it can be ascertained it is as much a fact as anything else. A misrepresentation as to the state of a man's mind is therefore, a misstatement of fact".

It is nevertheless noteworthy that a party who truly states his present intention but then changes his mind does not incur any liability unless he is bound by a promise not to do so.[66] Moreover, a statement of intention that something will happen in the future would normally not be treated as a statement of fact[67] unless the statement has a continuing effect. That said, there may be a duty to correct or inform a change in intention, and a failure to do so may give rise to liability in certain circumstances.[68] For the purpose of comparison, two cases should be mentioned: the first is *Wales v Wadham*,[69] where the plaintiff and the defendant, who were formerly husband and wife, agreed in the course of divorce proceedings that the wife would not remarry in exchange of getting greater financial benefit from the divorce. By the time of signing the agreement the wife had changed her mind but did not tell this fact to the plaintiff, who subsequently wanted to rescind the agreement on the ground of misrepresentation. The court held that wife's statement was based on her honest intention at that time and she was under no obligation to disclose any subsequent

---

[64] (1885) 24 Ch.D 459

[65] *Ibid.*, 483

[66] *Kleinwort Benson Ltd. v Malaysia Mining Corporation Berhad* [1989] 1 WLR 379: the plaintiffs were merchant bankers who made a loan to the subdivision of the defendant relying on a comfort letter from the defendant saying that: "it is our policy to ensure that the business of the subsidiary is at all times in a position to meet its liabilities". The subdivision of the defendant went bankrupt, and the defendant refused to pay a loan given by the plaintiff. The Court of Appeal held that the above statements were not a promise as to future conduct and that no future conduct could be implied. Accordingly, the statement was not binding and the defendant had no liability in this regard.

[67] *Inntrepreneur Pub.Co v Sweeney* [2002] EWHC 1060 (Ch)

[68] *Inclusive Technology v Williamson* [2009] EWCA Civ 718

[69] [1977] 1 WLR 199

change of the intention and therefore the plaintiff's claim failed. In this case, the wife's statement could not be regarded as a continuing representation to the future. However, in the second case of *Inclusive Technology v Williamson*,[70] the landlord served a statutory termination notice of the tenancy to the tenant on the basis that he intended to do some refurbishment. However, he changed his mind later due to the cost concern but did not tell this change to the tenant. The Court of Appeal held that the representation made by the landlord only made sense if it was a continuing one, with the result that landlord was subject to a duty to inform the tenant if he changed his mind, failing to do so may trigger the liabilities on his part.

[1.11] Thirdly, it is traditionally considered that a statement of law is non-factual and, therefore, a contract could not be rescinded on the basis of a misrepresentation or mistake of law,[71] nor could the money be recovered if paid by mistake of law rather than fact.[72] However, this proposition has been criticized in several occasions. For instance, in *Solle v Butcher*,[73] the court considered that if a dwelling house was represented to be "new" for the purposes of the Rent Act 1977, was the nature of this representation in fact or in law? The court held that this was not merely an expression of an opinion on the law: this was an unambiguous statement as to private rights, and a misrepresentation as to private rights was equivalent to a misrepresentation of fact. Similarly, it was also criticized that there was no good reason why a willful misrepresentation of law should not be treated in the same way as a statement of opinion which was not actually held.[74]

In 1999, the House of Lords corrected this position in the case of *Kleinwort Benson Ltd v Lincoln City Council*[75]and held that money paid by mistake of law could be recovered on the same basis as if the mistake had been factual. In addition, in

---

[70] [2009] EWCA Civ 718

[71] *Eaglesfield v Londonderry (Marquis)* (1876-1877) 4 Ch D 693

[72] *Bilbie v Lumley* (1802) 2 East.469

[73] [1950] 1 KB 671, 695

[74] *West London Commercial Bank v Kitson* (1884) 13 QBD 360, 362

[75] [1999] 2 AC 349

Pankhania v Hackney London Borough Council,[76] a representation concerned a statement of law that the occupier of the car park was a contractual licensee whose occupation could be terminated on three months' notice was in fact untrue as the car park user was protected as a business tenant under the Landlord and Tenant Act 1954. The court held that this statement of law was an actionable misrepresentation for the purpose of Misrepresentation Act 1967. Therefore, in principle in the law of deceit misrepresentation of law could be treated the same as misrepresentation of fact.

[1.12] In brief, it seems that a clear line is not easy to draw between the statement of fact and other types of statement. More importantly, it is attractively submitted that the fraud of the representor overrides the policy reason for distinguishing between a statement of fact and a statement of opinion, law or intention.[77] Accordingly, for the purpose of establishing liability for fraud, it may be better to discard the rule that the representation be one of fact, and simply to say that the rule applies to any fraudulent statements which are intended to deceive. In other words, the true position should be "whether the statement is made fraudulently or not. If fraudulent, it suffices."[78]

---

[76] [2002] EWHC 2441 (Ch)

[77] Cartwright, J, *Misrepresentation, Mistake and Non-disclosure*, 3rd edn, Sweet&Maxwell (2012), 3-13, 3-33 and 5-08. It is submitted that the policy reason behind the distinction is "the courts' desire to limit the actionable misrepresentations to those on which a representee ought to be entitled to rely". However, "*fraus omnia corrumpit*":"fraud unravels all", "it vitiates judgments, contracts and all transactions whatsoever". *Lazarus Estates Ltd v Beasley* [1956] 1 QB 702, 712 (Denning LJ)

[78] *Ibid.*, 4-25. It is commented that the attraction of this approach is that the rule focuses on the crucial issue which is whether the claimant has been deceived by what has been said. This is really the only issue worthy of considering and any concerns of the court on whether the claimant should have been influenced by what the deceiver said can be dealt with by placing the burden on the claimant to establish he was so influenced in fact (it is also doubted that the court should adopt an objective test of what would influence an objective reasonable by-stander). Deceiver can hardly argue that the claimant turns out be gullible. See McGrath, P, *Commercial Fraud in Civil Practice*, Oxford (2008), 2.10

B. The falsity of the representation

[1.13] The claimant has the burden of proof[79] to give indications that the representation is false.[80] It is submitted that the falsity of the representation will depend upon two elements: the meaning of the representation and its variance from the truth.[81]

[1.14] It is noteworthy that a representation may mean one thing to the representor, but another thing to the representee, and yet another thing to a reasonable person in the position of the representor or the representee.[82] It is not simply the literal meaning of the representation matters, the representation is untrue if the representee "was justified in understanding, and did understand it, in the sense which is false."[83] Thus, the real test is suggested to be whether (a) the words or conduct in fact leads the representee to believe the alleged false fact, and (b) it is reasonable for the representee to believe it from the words or conduct as he perceived them.[84] Accordingly, two situations should be distinguished particularly in the circumstances where the meaning of representation is ambiguous: to start with, "if a person makes a representation of that which is true, if he intends that the party to whom the representation is made should not believe it to be true, that is a false representation";[85] on the contrary, if a statement seems literally untrue, but is not intended to be interpreted in its false sense, it does not constitute fraud. The later situation was illustrated in the case of *Akerhielm v De Mare*:[86] the claimant who had relied on an ambiguous statement in a company prospectus failed in his action in fraud as it was shown that the defendants had honestly believed the statement to be true in the sense

[79] See Chapter Three in general

[80] *Smith v Chadwick* (1844) 9 App.Cas.187

[81] Eggers, PM, *Deceit The Lie of Law*, Informa (2009), 3.36

[82] *Krakowski v Eurolynx Properties Ltd* [1994] HCA 22, [23]-[24]

[83] *Smith v Chadwick* (1844) 9 App.Cas.187, 190

[84] Cartwright, J, *Misrepresentation, Mistake and Non-disclosure*, 3rd edn, Sweet&Maxwell(2012), 3-06

[85] *Moens v Heyworth* (1842) 10 M&W 147, 158(Alderson B)

[86] [1959] AC 789

which they had intended it to be read. In other words, it is the objective meaning of the representation that has to be identified in order to determine the falsity of the representation.

[1.15] It shall also be noted that it is unlikely to require a representation to be true in all respects and every sense and therefore, the question would be: is a representation true if in substance it is true, even if to some extent? The answer was considered by Rix J in the case of *Avon Insurance plc v Swire Fraser Ltd.*[87] His Lordship, by adapting the statutory test of truth set out in Section 20 (4) of Marine Insurance Act 1906 which states that "a representation as to a matter of fact is true, if it be substantially correct, that is to say, if the difference between what is represented and what is actually correct would not be considered material by a prudent insurer", was of the opinion that: [88]

> "a representation may be true without being entirely correct, provided it is substantially correct and the difference between what is represented and what is actually correct would not have been likely to induce a reasonable person in the position of the claimants to enter into the contracts."

Furthermore, telling half truth that is intended to cover the falsehood may amount to fraud, as Lord Cairns suggested in *Peek v Gurney*:[89]

> "There must…be some active misstatement of fact, or, in all events, such a partial and fragmentary statement of fact, as that the withholding of that which is not stated makes that which is stated absolutely false."

The example was given by James LJ in the case of *Arkwright v Newbold*:[90]

> "Supposing you state a thing partially, you may make as false a statement as much as if you misstated it altogether. Every word may be true, but if you leave out something which qualifies it you may make a false statement. For instance, if pretending to set out the report

[87] [2000] 1 ALL ER (Comm) 573

[88] *Ibid.*, [17]

[89] (1873) LR 6 HL 377, 403

[90] (1881) 17 Ch D 301, 318

of a surveyor, you set out two passages in his report, and leave out a third passage which qualifies them, that is an actual misstatement."

The same opinion was also shared by Lord Steyn in a modern case *Smith New Court Securities Ltd v Scrimgeour Vickers (Asset Management) Ltd*:[91]

> "A cocktail of truth, falsity and evasion is a more powerful instrument of deception than undiluted falsehood."

Thus, liability for fraud may be incurred when the representor makes the statements which are true but which are misleading because the statements do not reveal all the relevant facts for the reference of the representee. In other words, concealment of certain material facts may render the stated representation false. In *Dimmock v Hallett*,[92] the seller of a land told the prospect purchaser that all the property on the land was fully let but suppressed the facts that the tenants had given notice to quit and he had failed to find a new tenant except at a lower rent. The statements gave the purchaser the false impression that the land would still have the high value and they were held by the court to be false. Similarly, in *Nottingham Patent Brick and Tile Co v Butler*,[93] a purchaser of the land asked the seller's solicitor whether the land was subject to restrictive covenants and received the reply that solicitor himself was not aware of this. However, solicitor did not say that this unawareness was due to his laziness to check. The court held that although this statement was literally true, it was still a false representation because the solicitor "allowed himself, in his zeal for his client, to make statements which were calculated to lead the other side to believe that he was stating facts within his own knowledge, and his statements in fact misled him, so that what he said amounts to a misstatement of facts."[94]

[1.16] Finally, a representation may be held as being false and therefore capable of incurring the liability of fraud, if the representor fails to correct the representation

[91] [1997] AC 254, 274

[92] (1866) LR 2 Ch App 21

[93] (1886) 16 QBD 778

[94] *Ibid.*, 787-788

which was true when it was made but subsequently became false or discovered by the representor to be false. The basis for this proposition could be that the representor is subject to a duty to communicate to the representee the change of circumstances in this particular context.[95] In *With v O'Flanagan*, [96] Dr O'Flanagan intended to sell his medical practice to the plaintiff and he represented that the income to be derived from the practice were £2000 per annum, which was true at the time of making the statements. Unfortunately, Dr O'Flanagan fell ill and the income fell to an average of £5 pound per week. This significant change of circumstances was not revealed to the plaintiff before the conclusion of the contract. The court held that the plaintiff was entitled to believe the truth of the statement made until the time of signing the contract and until it was correct. The underlying principle was neatly summarized by Lord Blackburn in *Brownlie v Campbell*[97] and was applied to this case:

> "When a statement or representation has been made in the *bona fide* belief that it is true, and the party who has made it afterwards comes to find out that it is untrue, and discovers what he should have said, he can no longer honestly keep up that silence on the subject after that has come to his knowledge, thereby allowing the other party to go on, and still more, inducing him to go on, upon a statement which was honestly made at the time when it was made, but which he has not now retracted when he has become aware that it can be no longer honestly persevered in..."

II. The Fraudulent Knowledge and the Intention of the Representor

[1.17] A person could be imputed with dishonest knowledge in various ways. In *Baden v. Société Générale pour Favoriser le Développement du Commerce et de l'Industrie en France S.A. (Note)*,[98] the various mental states were analyzed by Peter Gibson J as comprising: (i)actual knowledge;(ii)wilfully shutting one's eyes to the

---

[95] *Davies v London and Provincial Marine Insurance Co* (1878) Ch D 469, 475 (Fry J). See Chapter Two for its application in insurance contract, at [2.44] and [2.45]

[96] [1936] Ch 575

[97] (1880) 5 App Cas 925, 950

[98] [1993] 1 WLR 509, [250]

obvious; (iii)wilfully and recklessly failing to make such inquiries as an honest and reasonable man would make; (iv)knowledge of circumstances which would indicate the facts to an honest and reasonable man; and (v)knowledge of circumstances which would put an honest and reasonable man on inquiry. According to Peter Gibson J., a person in category (ii) or (iii) will be taken to have actual knowledge, while a person in categories (iv) or (v) will be taken to have constructive knowledge only. Stuart-Smith LJ in *Commissioner for the New Towns v Cooper (Great Britain) Ltd*[99] further discussed the relationship between categories (iv) or (v) and the actual knowledge of dishonest:

> "If a man does not draw the obvious inferences or make the obvious inquiries, the question is: why not? If it is because, however foolishly, he did not suspect wrongdoing or, having suspected it, had his suspicions allayed, however unreasonably, that is one thing. But if he did suspect wrongdoing yet failed to make inquiries because 'he did not want to know' (category (ii)) or because he regarded it as 'none of his business' (category (iii)), that is quite another. Such conduct is dishonest, and those who are guilty of it cannot complain if, for the purpose of civil liability, they are treated as if they had actual knowledge."

In short, in order to be liable for fraud, the representor must have known the falsity of the representation. In the light of *Derry v Peek*,[100] there could be two limbs of this fraudulent knowledge, as Lord Herschell said that: "fraud is proved when it is shown that a false representation has been made (i) knowingly, (ii) without belief in its truth, or (iii) recklessly, careless whether it be true or false"[101] and his Lordship further explained that "the third is but an instance of the second".[102] Thus, first of all, the representor will have known that the statement is untrue if he or she possesses the actual knowledge of the falsehood; secondly, at least, he or she is consciously reckless to the truth of what he or she represents.

---

[99] [1995] Ch 259, 280-281

[100] (1889) 14 App Cas 337

[101] *Ibid.*, 376

[102] *Ibid.*

A. The first limb of fraudulent knowledge: actual knowledge

[1.18] In order to for the representor of a statement to be guilty of fraud, there is little difficulty to require the representor to have the actual knowledge that the statement is untrue. Actual fraud means what it says. It does not mean "constructive fraud" or "equitable fraud". The word "actual" is deliberately chosen to exclude them.[103] It is submitted that in the case of an individual, actual knowledge suggests that the representor must firmly believe that the representation is untrue. However, the situation may not be straightforward in the case of involvement of the agent or company fraudsters where it needs to be considered the attribution of conduct from the agent to the principal or from the company's employee to the company.

(a) Attributing agent's knowledge to the principal[104]

[1.19] In the case of an agent being involved in the transaction, if the agent possesses actual fraudulent knowledge and commits fraud while performing his duties for the principal, the principal may face either primary or vicarious liability jointly with the agent. On the one hand, if the principal authorizes, approves or condones the making of the false statement of the agent, regardless whether or not the agent is innocent in the sense that the agent may not be aware of the falsity of the statement, the principal will attract the primary liability. On the other hand, where the agent has acted within the scope of his apparent authority[105] but has caused damage to a third

[103] *Armitage v Nurse* [1998] 1 Ch 241, 250 (Millett LJ)

[104] It is not uncommon that the fraudulent insurance claim is submitted by the agent of the insured. The legal principle governing this issue has no difference with the one in agency law and accordingly, the implication of this issue is discussed in this Chapter.

[105] In *Quinn v CC Automotive* [2010] EWCA Civ. 1412, [23], it was further held by Gross LJ that "it is a necessary condition of the employer's liability to the third party for the deceit of the employee that the representation, as to the employee's authority in respect of the transaction in question, was relied upon by the third party." In other words, the third party must honestly believe in the employee's authority and should not turn a blind eye to suspicions as to the authority of the employee. However, it was also held that the victim's honest belief does not have to be reasonable. The fact that it was unreasonable not to see through the employee's deceit does not of itself invalidate the third party's reliance. In other words, for the purpose of finding the apparent

party due to the fraud, the principal will be vicariously liable to the third party even if he has no actual fraudulent knowledge and plays no part in the fraud activities. This situation was illustrated clearly in *Lloyd v Grace Smith.*[106] In that case, the managing clerk of a firm of solicitors, acting as the representative of the firm, induced a widow, who owned two cottages and a sum of money secured on a mortgage but being dissatisfied with the income derived therefrom, to give him instructions to sell the cottages and to call in the mortgage money, and for that purpose to give him her deeds (for which he gave a receipt in the firm's name); he also asked her to sign two documents, which were neither read over nor explained to her, and which she believed she had to sign in order to effect the sale of the cottages. These documents were in fact a conveyance to the managing clerk of the cottages and a transfer to him of the mortgage. He then dishonestly disposed of the property for his own benefit. It was held by the House of Lords that the firm was responsible for the fraud committed by its representative in the course of the employment.

In contrast, if the representation is made innocently by the agent but the principal alone knows that the representation is false, the action against fraud may not succeed. In *Armstrong v Strain,*[107] Strain employed a firm of estate agents to find a purchaser for his bungalow. Skinner, a member of that firm, made an untrue representation regarding the value of bungalow to the plaintiffs. The plaintiffs believed it and purchased the bungalow. Strain did not authorize Skinner, his agent, to make the representation and did not know Skinner was making it, but he knew of facts which rendered it untrue; i.e., if he had made it himself to the plaintiffs he would have been guilty of fraudulent misrepresentation. The plaintiffs brought an action against Strain and Skinner for fraudulent misrepresentation. It was argued that the representation made by Skinner being untrue to the knowledge of Strain (though not to the knowledge of Skinner), principal and agent being one in law, fraud was thereby established. The trial judge found that neither Strain nor Skinner was guilty of fraud, and it was further supported by the Court of Appeal that there is no authority for the view that the innocent acts or intentions of a principal or his agents, whatever

---

authority, whether it is unreasonable for the third party to believe that the employee seems to have his employer's authority is immaterial.

[106] [1912] AC 716

[107] [1951] 1 TLR 856(High Court); [1952] 1 KB 232 (Court of Appeal)

detrimental effect they may have on a third party, could amount to a fraudulent misrepresentation upon which such third party can bring an action in fraud

In brief, the position in which the agent being engaged was concisely summarized by Atkinson J. in *Anglo-Scottish Beet Sugar Corporation Ld. v. Spalding Urban District Council*:[108]

> "A principal was liable for the fraudulent representations of his agent, although those representations reached the third party through and by the innocent channel of the principal, just as the principal would be liable if he, the principal, fraudulently caused an innocent agent to communicate a misrepresentation to the third party."

More explicitly, a serious of propositions has been best summarized as follows:[109]

- The principal is liable if he authorized that the agent to make the false representation which the principal knew to be untrue (or did not believe to be true), whether the agent knew the truth or not.
- The principal is liable if, while not expressly authorizing the agent to make the false representation, he knew it to be untrue and was guilty of some positive wrongful conduct, as by consciously permitting the agent to remain ignorant of the true facts, so as to prevent the disclosure of the truth to the third party, if the third party should ask the agent for information, or in the hope that the agent would make some false representation. The agent's representation when made would of course require to be within the scope of his actual or apparent authority.
- The principal is liable if the agent made the false representation fraudulently, it being within the scope of his actual or apparent authority and within the course of his employment, to make such a representation, sometimes even where the representation reached the third party by way of another agent, or by way of the innocent principal himself, because in such a case the innocent second agent or principal may be no more than a conduit for the fraud of the guilty agent.

[108] [1937] 2 KB 607, 621

[109] Reynolds, FB (Ed), *Bowstead&Reynolds on Agency*, 19th edn, Sweet&Maxwell (2010), 8-185; *Armstrong v Strain* [1952] 1 KB 232

- The principal is not liable if the agent made the false representation innocently, the principal knowing the true facts but not having authorized the agent to make the representation, nor knowing that it would be made, nor being guilty of fraudulent conduct as stated above.

- Conversely, the principal is not liable if he himself made the false representation innocently, notwithstanding that the agent knew the true facts.

(b) Attributing employee's knowledge to the company: the *alter ego* of the company[110]

[1.20] If the company is involved, the key question is identifying the individual whose knowledge could be attributed to the company. Ordinarily, the *alter ego* test will apply to attribute responsibilities. The classical statement of *alter ego* test could be found in *Lennard's Carrying v Asiatic Petroleum*:[111] the *alter ego* could be the person or persons "who is or are really the directing mind and will of the corporation, the very ego and centre of the personality of the corporation". It is further submitted that the search would be to draw the circle round the natural persons which fairly reflected the equivalent position to that which would prevail where a natural person was the insured.[112]

It is noticeable that the *alter ego* of a company is not necessarily restricted to the board of directors. In the well-known decision of *The Lady Gwendolen*[113], the act of a senior manager below broad level was held to constitute the direct mind and will of the company. Williams LJ held that: "...in the present case, a company has a separate traffic department, which assumes responsibility for running the company's ships, I

[110] If the insured is a company, for the purpose of establishing the fraud, it must be shown that his *alter ego* is guilty of fraud. The test for determining the *alter ego* is not peculiar to insurance law and accordingly, is discussed in this Chapter. See also Chapter Two, at [2.8], in the context of Section 55 of the Marine Insurance Act 1906.

[111] [1915] AC 705

[112] *The Star Sea* [1997] 1 Lloyd's Rep. 360, 375. In the context of Section 39 (5) of Marine Insurance Act 1906.

[113] [1965] 1 Lloyd's Rep. 335

see no good reason why the head of that department, even though not himself a director, should not be regarded as someone whose action is the very action of the company itself, so far as concerns anything to do with the company's ships."[114] However, it is rightly warned by Mustill LJ that: "any director must necessarily be a member of the group unless formally dis-seised of responsibility...Thus, I would prefer to steer clear of generalisations about the constituent elements of the alter ego. Each case must turn on its own facts."[115] Furthermore, in a Privy Council case of *Meridian Global Funds Management Asia Ltd v The Securities Commission*,[116] it is suggested that "directing mind and will" test may not be applicable on all occasions to all statutory provisions and, therefore, whether the company has knowledge of a certain fact must be determined by the rules of attribution.[117] Their Lordships differentiated the primary, general, and special rules of attribution. The primary rules of attribution, which will generally be found in company's constitution, typically the articles of association, or implied by company law, refer to the acts specifically authorized by a resolution of the board or a unanimous decision of the shareholders. However, primary rules of attribution are obviously not enough to enable a company to go out into the world and do business, so it should be supplemented by the general rules which are equally available to natural persons, namely, the principles of agency, estoppel or ostensible authority in contract and vicarious liability in tort. However, in certain cases, the primary and general rules may not work properly: "for example, a rule may be stated in language primarily applicable to a natural person and require some act or state of mind on the part of that person 'himself,' as opposed to his servants or agents."[118] Depending on the different circumstances, it is necessary to identify the person or persons within the company who are involved in the decision-

---

[114] *Ibid.*, 345

[115] *The Ert Setfanie* [1989] 1 Lloyd's Rep.349, 352

[116] [1995] 2 AC 500

[117] Lord Hoffmann said that: "A company exists because there is a rule (usually in a statute) which says that a persona ficta shall be deemed to exist and to have certain of the powers, rights and duties of a natural person. But there would be little sense in deeming such a persona ficta to exist unless there were also rules to tell one what acts were to count as acts of the company." The rules of attribution constitute a necessary part of corporate personality by which acts are attributable to the company, *ibid.*, 506

[118] *Ibid.*, 507

making process required for possessing fraudulent knowledge. It is only the knowledge of these persons regarding the acts or omissions that can be attributable to the knowledge of the company. It is a question of fact in each case to determine the outcome; the knowledge of directors or senior employees who are not engaged in dishonest conduct will not necessarily be attributable to the company. A classical example was given by Lord Cranworth LC in *The National Exchange Company of Glasgow v Drew*:[119]

> "If the Directors in the discharge of their duty of making these annual reports, and giving a correct representation as to the state of the funds of the Company, fraudulently, and with a view to raise the value of the shares of the Company in their annual reports, misrepresent what the state of the Company is, under such circumstances, that third persons, or even shareholders, (who for this purpose we may treat as third persons), are deceived and act upon that misrepresentation, the persons so deceived and so acting have a right to treat themselves as having been fraudulently deceived by the Company."

[1.21] There is an exception to the principle of attribution stated above, which was established by *Re Hampshire Land*,[120] that a company will not have attributed to it knowledge of a fraud when that fraud is being practiced on the company itself. The law does not attribute knowledge of a deception to the person who is being deceived. However, the *Re Hampshire Land* exception may not come into play in determining whether a company should be fixed with primary liability for the wrongdoings or omissions of its agent, and furthermore, if the case in question is a "sole actor" case in which the agent and the company are one person, exception would too not be applicable. For instance, in *Moore Stephens v Stone &Rolls Ltd*,[121] the company S&R in question was controlled by an individual Mr. S who procured the company to present false documents to banks against which payment was made by the banks under letters of credit. The transactions in respect of which the letters of credit were issued related to goods which did not exist. The bank obtained judgment

[119] (1855) 2 Macq 102, 124-127

[120] [1896] 2 Ch 743

[121] [2009] 1 AC 1391. The detailed analysis of this case, see Merkin,R, *Fraud and Insurance Agents: The Law after Moore Stephens*, Chapter 4 of *The Modern Law of Marine Insurance, vol.3*, Thomas, DR,(Ed), Informa (2009)

against the company and Mr S. for fraud, and the company subsequently went into insolvent liquidation. The liquidators of the company then brought proceedings against its auditor Moore Stephens, alleging that the auditor had been negligent in carrying out the audits in those years in failing to detect and prevent S's dishonest activities in procuring the company to engage in frauds on banks. The auditor denied liabilities on the basis of *ex turpi causa non oritur* and argued that the company was debarred from recovering from damages because the company was relying on its own fraud. The majority of the House of Lords held that the company and Mr. S were indistinguishable so Mr.S's conduct was attributed to the company who shall bear the primary liability for the fraud.

[1.22] Finally, it is to be noted that sometimes the principal wants some protection against possible misstatements by an agent. This issue was raised in an insurance case of *HIH Casualty and General Insurance Ltd. and Others v Chase Manhattan Bank and Others.*[122] The insurers in that case alleged that during the pre-contractual stage, the brokers had made certain fraudulent, reckless or negligent misrepresentations and/or non-disclosures on behalf of the insureds. The insureds defended the claim on the grounds that each insurance policy contained a "Truth of Statement" Clause in the condition precedent section of the policy which stated that "…it being acknowledged that any misstatement in any part of the questionnaire…shall not be the responsibility of the insured or constitute a ground for avoidance of the insurer's obligation under the Policy or the cancellation thereof". The purpose of the clause was an attempt to protect insureds from any misrepresentations or non-disclosure perpetrated by their brokers. The Court of Appeal decided that the Truth of Statement clause did in fact exclude not only the insurers' right to avoid or rescind the policy but also their right to claim damages from the insureds as a result of the insureds' brokers' negligence or non-disclosure. However, on the wording of this particular clause the insurers would still have been entitled to rescind the policy if there had been fraud and claim damages for deceit. The clearest possible wording would be required to seek to exclude remedies in respect of fraud. The decision was supported by the House of Lords. Their Lordships found that the Truth of Statement clause in the policy

[122] [2003] 2 Lloyd's Rep.61

excluded liability for innocent or negligent misrepresentation on the part of the agent. Their Lordships held that parties entering into a commercial contract would recognize and could make provision for the risk of innocent or negligent errors and omissions but each would assume the honesty and good faith of the other. However, due to the reason of public policy, a party to a contract could not stipulate that he could not be liable for his own deliberate, dishonest or reckless non-disclosure or fraud.

B. The second limb of fraudulent knowledge: recklessness

[1.23] It was described by Willes J that it is equally fraudulent if the statements are made in the knowledge that they are false or with a reckless disregard of whether they are true or not, or not knowing whether they are true or false, and careless whether they are true or not.[123] This description is in accordance with the "third case" stated by Lord Herschell in *Derry v Peek.*[124] Further comments regarding the meaning of recklessness will be developed as follows.

[1.24] In *Medd v Cox,*[125] a motor cruiser was bought by the plaintiff and the defendant was the ostensible vendor. The launch was described as having "new Morris Navigator engine", as being in "exceptional condition", and as having "originally cost over £1000". However, upon inspection, the vessel was found to be in very bad condition. The plaintiff on the sale of that vessel claimed the damages for fraudulent misrepresentation. The trial judge found the statement was false by saying that "she was not in exceptionally good condition. In fact, she was rather in exceptionally bad condition and she had not cost anything like £1000",[126] but his reasoning that "the description of that ship was fraudulent because no case was taken

[123] *The Glamorganshire Iron and Coal Company v Irvine* (1866) 4 F&F 947, 955-956

[124] (1899) 14 App Cas 337

[125] (1940) 67 Ll.L.Rep.5

[126] *Ibid.*,

about the accuracy and no case was taken about the description"[127] was criticized in the appeal. Sir Wilfrid Greene MR stated the principles that:[128]

> "It is to be remembered that in order to sustain a case of fraud, it is quite insufficient to prove that the untrue statement was made carelessly. What it is necessary to prove is a guilty state of mind in the person making the statement. He must either know that his statement is untrue or he must make it recklessly not caring whether it is true or false. That guilty mind must exist, and unless one or other of those two facts is established with regard to the state of mind of the defendant, no finding of fraud can be supported in law. "

Considering the relevant evidence and applying the test to the facts of the case, it was concluded by the Master of Rolls that there was no evidence upon which it could be properly be found that the defendant's statement, that he believed those statements when he made them, was untrue. For example, with regard to the statement "exceptional condition", the Master of Rolls ruled that the defendant Mr Cox "was familiar with the vessel, he had used her himself, he had seen her on the slip, he had contemplated purchasing her and had had her examined by an expert. In those circumstances, unless there was some other evidence or something in his demeanour when he gave his evidence which would lead to a disbelief in his veracity, it seems to me his evidence must be accepted."[129]

[1.25] In *Blackburn Low & Co v Vigors*,[130] Lord Halsbury LC considered a situation when a man came for insurance on his ship he may be expected to know both the then condition and the history of the ship he sought to insure. If he took means not to know, so as to be able to make contracts of insurance without the responsibility of knowledge, this might constitute a fraud too. This fraudulent knowledge might be illustrated as "blind eye knowledge" [131]where the representor has knowledge that the

---

[127] *Ibid.*,

[128] *Ibid.*, 6

[129] *Ibid.*, 7

[130] (1887) 12 App Cas 531, 536-537

[131] The relationship between "blind eye knowledge" and "recklessness" is further discussed in Chapter Two, at [2.13]

statement may not be true and deliberately decides to fail to inform others.[132] Similarly, if the representor makes a representation about a fact or state of affairs of which he or she has no knowledge, this would also be the situation of fraudulent knowledge.

[1.26] Recklessness must be understood in the context of dishonesty, so it was neatly summarized by Lord Buckmaster in *Donoghue v Stevenson*[133] that "no action based on fraud can be supported by mere proof of negligence", even the gross and culpable negligence is not enough.[134] Fraud imports design and purpose, but negligence imports that the relative person are acting carelessly and without that design. Similarly, in *Smith v Chadwick*[135] Lord Blackburn described that:

> "…a man may make a statement which he intended to mean one thing but which negligently and stupidly he sends out in such a shape as to bear another meaning, and a plaintiff acts upon that meaning…the defendant in such a case would have great difficulty in establishing that it was only honest blundering, but if he did…I should say it was not fraud, though perhaps gross negligence."

[1.27] In *The Kriti Palm,*[136] the claimant buyer AIC purchased the gasoline from the seller M and both parties agreed that the quantity and the quality of the gasoline was to be determined at the loading port by mutually acceptable independent inspectors appointed by M, the result of which would be conclusive and binding save for fraud and manifest error. The defendant inspection company ITS issued the certificate stating "Fuel meets Specification" but it turned out that the wrong test was used in inspection. AIC entered into a sub-sale contract and an argument was raised by the sub-buyer as to whether he should pay for the goods and take delivery of it because the gasoline was off-specification. AIC lost the sub-sale case in the Swiss Supreme

---

[132] *Petromec Inc v Petroleo Brasiliero SA* [2007] 1 Lloyd's Rep.629, [94] (Gloster J)

[133] [1932] 1 AC 562, 570

[134] *Armitage v Nurse* [1998] 1 Ch 241, 250 (Millett LJ). The meaning of gross negligence is briefly discussed below. See the footnote of [1.28]

[135] (1844) 9 App.Cas.187, 201

[136] [2007] 1 Lloyd's Rep.555

Court and then sought to commence proceedings against M in the first place, which were subsequently compromised and then against the defendant ITS for damages arising out of, *inter alia*, deceit. The main argument for defendant's commitment of deceit was based upon a telephone conversation between the general manager of ITS Mr Lucas and Mr Whitaker who was acting on behalf of AIC. During that telephone call, Mr Lucas told Mr Whitaker that "it was impossible to go back into any of the samples because no samples are kept under ice". Mr Whitaker told Mr Lucas that AIC had a quality certificate from ITS saying that the cargo was on-specification. Mr Lucas replied "we will be standing by that certificate". In response to Mr Whitaker's comment that the test must be inaccurate due to the use of wrong test method, which was known to Mr Lucas as a re-test had been conducted, he simply said "I can't say whether it is inaccurate or not". The trial judge Cresswell J found that considering the conversation as a whole, Mr Lucas had been guilty of deceiving Mr Whitaker. His Lordship found that what was implied in the words of Mr Lucas was a representation that the certificate was good and valid, or good and reliable, and that, by reason of knowing the re-test results, Mr Lucas was reckless as to the truth of that implied representation. ITS appealed on this issue. The Court of Appeal allowed the appeal and ruled that Mr Lucas did not make any representation that the certificate was good and reliable. Although he said that ITS would be standing by the certificate, he had made it plain that he did not know whether the actual values in the certificate were correct. Moreover, although Mr Lucas was aware of the result of the re-test, the full implication of the information was not conscious to his mind so as to render him potentially dishonest in anything he said.[137] Rix LJ, who delivered the leading judgement, summarized the law at length in this regard. His Lordship said that:[138]

> "As for the element of dishonesty, the leading cases are replete with statements of its vital importance and of warnings against watering down this ingredient into something akin to

[137] Nevertheless, in this case, the majority of the Court of Appeal found that ITS was guilty of deliberate concealment on the ground that an inspection company which issued a certificate of cargo quality owed a duty to its employer to disclose the results of subsequent tests carried out by it which case doubt on the accuracy of the certificate. The fact that ITS had been acquitted in deceit did not preclude a finding that ITS had engaged in deliberate concealment.

[138] [2007] 1 Lloyd's Rep.555, [256]-[258]. Those paragraphs were also cited by Eder J in *Aviva Insurance Ltd v Brown* [2011] EWHC 362 (QB), [69]

negligence, however gross...In effect, recklessness is a species of dishonest knowledge, for in both cases there is an absence of belief in truth. It is for that reason that there is 'proof of fraud' in the cases of both knowledge and recklessness."

Two significant speeches were cited by his Lordship which deserved to be fully repeated as follows. The first was made by Bowen LJ in *Angus v Clifford*[139] where his Lordship said that:

"Not caring, in that context, did not mean not taking care, it meant indifference to the truth, the moral obliquity of which consists in a wilful disregard of the importance of truth, and unless you keep it clear that that is the true meaning of the term, you are constantly in danger of confusing the evidence from which the inference of dishonesty in the mind is to be drawn - evidence which consists in a great many cases of gross want of caution - with the inference of fraud, or of dishonesty itself, which has to be drawn after you have weighed all the evidence."

The second was made by Devlin J in *Armstrong v Strain*,[140] who stressed the need for dishonesty that:

"A man may be said to know a fact when once he has been told it and pigeon-holed it somewhere in his brain where it is more or less accessible in case of need. In another sense of the word a man knows a fact only when he is fully conscious of it. For an action of deceit there must be knowledge in the narrower sense; and conscious knowledge of falsity must always amount to wickedness and dishonesty. When Judges say, therefore, that wickedness and dishonesty must be present, they are not requiring a new ingredient for the tort of deceit so much as describing the sort of knowledge which is necessary."

The summary made by Rix LJ and those passages cited above are commented by Flaux J in *Grosvenor Casinos Ltd v National Bank of AbuDhabi*[141] that:

"*The Kriti Palm* is a salutary reminder to any judge as to the importance of not confusing fraud with incompetence, even if it amounts to gross negligence and as to the importance of being satisfied to the necessary heightened standard of proof that was involved is dishonesty."

---

[139] [1891] 2 Ch 449, 471

[140] [1951] 1 TLR 856, 871

[141] [2008] 2 Lloyd's Rep.1, [106]

[1.28] Although it is stressed repeatedly that gross negligence[142] is not fraud, it nevertheless was acknowledged that gross negligence might amount to evidence of fraud, if it were so gross as to be incompatible with the idea of honesty,[143] as Lord Cranworth suggested that:[144]

> "If a little more care and caution must have led the directors a conclusion different from that which they put forth, this may afford strong evidence to show that they really did not believe in the truth of what they stated, and so that they were guilty of fraud."

[1.29] To sum up, the recklessness is concerned with those cases where the representor does not have sufficient certainty to know the true state of affairs, but take steps, or chooses not to take steps, in order to isolate his or her mind from the truth.[145]

C. The Fraudulent Intention of the Representor

[1.30] The second ingredient of subjective aspect of fraud is the representor shall have the intention to defraud the representee. Two points are noteworthy in this respect: (1) the representation must be made with the intent that the representee should act upon it; and (2) motive is generally irrelevant.

---

[142] In a recent High Court's decision *Camarata Property v Credit Suisse Securities* [2011] EWHC 479, [161], Andrew Smith J was of the opinion that the difference between negligence and gross negligence is one of degree and not kind (indicating that gross negligence is not wholly divorced from simple negligence). While this difference is not easy to define or even describe with any precision, it is likely be capable of embracing not only conduct undertaken with actual appreciation of the risks involved, but also serious regard or indifference to an obvious risk. In addition, High Court of Ireland in a recent case *ICDL GCC Foundation FZ-LLC v the European Computer Driving Licence Foundation Limited* [2011] IEHC 343 held that gross negligence means "a degree of negligence where whatever duty of care may be involved has not been met by a significant margin".

[143] *Le Lievre v Gould* [1893] 1 QB 491, 501

[144] *Western Bank of Scotland v Addie (*1867) LR 1 Sc&Div 145, 168

[145] Eggers, PM, *Deceit The Lie of Law*, Informa (2009), 5.23

(a) The representation must be addressed to the misled representee

[1.31] In *Bradford Third Equitable Benefit Building Society v Borders*,[146] Viscount Maugham stated that:

> "[The representation]...must be made with the intention that it should be acted upon by the plaintiff or by a class of persons which will include the plaintiff, in the manner which resulted in the damage to him"

It could be seen that the statement is not required to be given specially to the individuals who relies on it. It is sufficient if the representor intends that a person in the position of the representee should act upon it, or it can be suggested that the statement should be focused upon the representee, directly or indirectly through the third party, and it should be relied upon by the representee broadly in the manner the representor intended. In *Langridge v Levy*,[147] in the course of a gun transaction, the seller knowingly and falsely warranted the quality of the gun to the claimant's father who made it clear that his intention was to let his son, who was the claimant, use the gun. The court held that the seller was liable to the claimant. In *Peek v Gurney*,[148] the plaintiff, who purchased the shares from the first applicants of shares, sued the promoters of a company on the basis that the information contained in a prospectus issued by them was false. The House of Lords held that the false statement in the prospectus was directed to the first group of shareholders and could not extend to the claimant who purchased the shares on the stock market. Thus, it must be borne in mind that limitations should be put on the situations in which "class of persons" is involved especially in the cases containing a chain of commercial contracts: "the fact that it goes further down the line *ad infinitum* does not mean that everybody who comes to know of it can rely on it."[149]

Moreover, it is noteworthy that a representor's foresight that his unlawful conduct may damage or will probably damage the claimant cannot be equated with intention for this purpose. It is material that the defendant should intend that his representation should be relied on by the person to whom he makes it, but it is wholly

---

[146] [1941] 2 ALL ER 205, 211

[147] (1838) 4 M&W 337

[148] (1873) LR 6 HL 377

[149] *Gorss v Lewis Hillman* [1970] Ch 445, 463G (Harman LJ)

immaterial with what object the lie is told.[150] The suggestion that the requirement of intention can be disregarded in effect if fraudulent knowledge is established and perhaps if the representee's reliance is foreseeable shall be respectfully rejected,[151] and Lord Nicholls's opinion in *OBG Ltd v Allan*[152] must be preferred:

> "Lesser states of mind do not suffice. A high degree of blameworthiness is called for, because intention serves as the factor which justifies imposing liability on the defendant for loss caused by a wrong otherwise not actionable by the claimant against the defendant. The defendant's conduct in relation to the loss must be deliberate. The defendant must *intend* to injure *the claimant*. This intent must be a cause of the defendant's conduct."

(b) Motive is generally irrelevant

[1.32] It is submitted for a long time that in order to establish the fraudulent intention of the representor, the motive behind making a false representation is irrelevant, as it is described by Lord Blackburn in *Smith v Chadwick*[153] that:

> "As a matter of law, the motive of the person saying that which he knows not to be true to another with the intention to lead him to act on the faith of the statement is immaterial. The defendants might honestly believe that the shares were a capital investment, and that they were doing the plaintiff a kindness by tricking him into buying them. "

Accordingly, the representor cannot defend himself by saying that he has a good motive for deception. In *Standard Chartered Bank v Pakistan National Shipping Corp. (No.2)*[154], the motive for falsifying the date of presentation of bill of lading is to facilitate and speed up the particular transaction or maritime trade generally, but the representor was still held to be guilty of deceit, as Evan LJ commented that "it is no defence to the charge of knowingly making a false statement that the master or agent believed that he was justified in doing so or that in the circumstances no harm would

[150] *Edgington v Fitzmaurice* (1885) 29 Ch D 459

[151] Beale, H(Ed.), *Chitty on Contracts*, 30th edn, Sweet&Maxwell (2008), 6-030 to 6-031

[152] [2008] 1 AC 1, [166]

[153] (1884) 9 App Cas 187, 201

[154] [2000] 1 Lloyd's Rep.218

result".[155] Nor can the representor justify his fraudulent act by saying that he is ill-treated by the representee. The position was illustrated in *Aviva Insurance Ltd v Brown.*[156] In this case, one of the reasons for the insured to commit the fraud was probably that he was frustrated and exasperated by the considerable delay on the part of the insurer in dealing with his claim over a long period of time. The court showed sympathy to the insured and was of the opinion that the sense of exasperation was based upon a perception genuinely held by the insured that he was treated badly by insurer for a period of time, but also stressed that such perception genuinely held was in any event no excuse for fraud.[157]

Nevertheless, motive still plays an important evidential role for the purpose of proving fraud[158] in the sense that "in trying to decide whether a person made a statement which he must have known to be false, it must be relevant to consider why he should have done so. A man is more likely knowingly to make a false statement if he has some reason for doing so." [159] For instance, in *The Kriti Palm,*[160] one of the considerations given by Rix LJ that Mr Lucas had not been dishonest was that he had no motive to make the false representation. His Lordship asked that:[161]

> "What would have been Mr Lucas's motive for being dishonest? What had he personally, or ITS, to gain by any dishonesty? He had nothing whatsoever to gain, he was being involved in the Kriti Palm for the first time. As for ITS, this was one among countless disputes. What had he, or ITS, to lose by dishonesty? Everything. Motive, of course, is unnecessary for dishonesty: but motiveless dishonesty by a senior and experienced manager is difficult to comprehend."

---

[155] *Ibid*, [3]. Similarly, in *KBC Bank v Industrial Steels (UK) Ltd* [2001] 1 Lloyd's Rep.370, [31], David Steel J held that "it is no defence that the person making the false statement believed that he was justified in doing so or that in the circumstances no harm would result".

[156] [2011] EWHC 362 (QB). See Chapter Two, at [2.37]

[157] *Ibid.*, [81]

[158] As it will be demonstrated in the Chapter Three in insurance context, motive, such as financial difficulties on the part of insured, will be a strong evidential indication in deciding whether the assured has committed the fraudulent claim. See Chapter Three, at [3.14]

[159] *Barings Plc (In Liquidation) v Cooper & Lybrand (No.2)* [2002] BCLC 410, [62] (Evans-Lombe J). See Chapter Three, at [3.14]

[160] [2007] 1 Lloyd's Rep.555

[161] *Ibid.*, [285]

Conclusion

As it will be seen in Chapter Two, in most circumstances, fraudulent claims in commercial insurance law are established on the fraudulent misrepresentations given by the insured. Therefore, the law governing the issue of fraudulent misrepresentations, namely, the law of deceit[162] should be regarded as a starting point for the discussion on fraudulent insurance claims. In this chapter, the essential elements of deceit are discussed in details,[163] so that the way towards the proper analysis of fraudulent insurance claims are paved accordingly.

[162] For the purpose of the thesis, the word "fraud" and the word "deceit" are used in an interchangeable fashion. See Jones, MA& Dugdale,A (Ed), *Clerk&Lindsell on Torts*, 20th edn, Sweet&Maxwell (2010), 18-01: "...the tort of deceit (sometimes called simple 'fraud')..."

[163] There is an important difference between the law of deceit in the context of tort and the law of deceit in the context of fraudulent insurance claims. For the purpose of succeeding in an action in tort of deceit, the claimant must show that he acted in reliance on the defendant's misrepresentation. See Jones, MA& Dugdale,A (Ed), *Clerk&Lindsell on Torts*, 20th edn, Sweet&Maxwell (2010), 18-34 to 18-38. However, the element of reliance is not necessary for the purpose of pleading fraudulent insurance claims. See Chapter Two, at [2.19]. Therefore, the element of reliance is not discussed in this thesis.

CHAPTER TWO

THE DEFITION OF FRAUD IN INSURANCE CLAIMS CONTEXT

A lie has speed, but the truth has endurance.

——Edger J Mohn

Introduction

[2.1] The *ratio* of the decision of the House of Lords in *Derry v Peek*[1] is that fraud can be defined as a false representation made knowingly, or without belief in its truth, or recklessly, careless whether it be true or false. This definition has been discussed in detail in the last chapter. In this chapter, the application of this classical definition in the context of insurance claims will be further considered.

[2.2] A Claim is usually understood as a demand by the insured for an indemnity or benefit under the policy.[2] When the loss suffered as a result of the insured perils, any communication or correspondence between the insured and the insurer afterwards are potentially qualified as being part of the claim as long as the claim is submitted to the insurer. In general, in order to identify whether these communications (representations) are fraudulent, references could be made to Chapter One. However, in the context of insurance claims, fraud could have its own special characteristics which are categorized in the following paragraphs. Furthermore, it is also acknowledged that the impact of fraudulent claim rule is superseded or exhausted by the rules of litigation: once litigation has begun, any false evidence submitted by the insured or any false

[1] [1889] 14 App Cas 337, 374 (Lord Herschell)

[2] Bennett, C, *Dictionary of Insurance*, 2nd edn, Prentice Hall(2004), 61

communications presented by the insured is not to be treated as fraudulent claim and it is procedure rules of the court that govern these issues.[3]

[2.3] A short definition of insurance fraudulent claims can be found in an early House of Lords case of *Lek v Mathews*.[4] In this case, the claimant Mr Lek was insured against loss or damage caused by theft in respect of his stamp collection in the aggregate amount of £44,000. The court was satisfied that there was a theft but the primary question was whether the statement that Mr Lek made with regard to the valuation of the stamps was true or false. In the course of deciding the case, Viscount Summer delivered his opinion as to the meaning of insurance fraudulent claims:[5]

> "As to the construction of the false claim clause, I think that it refers to anything falsely claimed, that is, anything not so unsubstantial as to make the maxim *de minimis* applicable, and is not limited to a claim which as to the whole is false. It means claims as to particular subject-matters in respect of which a right to indemnity is asserted, not the mere amount of money claimed without regard to the particulars or the contents of the claim; and a claim is false not only if it is deliberately invented but also if it is made recklessly, not caring whether it is true or false but only seeking to succeed in the claim."

A much more detailed definition of insurance fraudulent claims can be found in the case of *Agapitos v Agnew*,[6] where Mance LJ, having reviewed the authorities, concluded tentatively that there are five categories of fraudulent claims in insurance law: (1) a claim where the insured knows that he has not, in fact, suffered any loss; (2) a claim where the insured knows that he has suffered a lesser than that which he has claimed; (3) a claim to which the insurer has a valid defence ,which is deliberately suppressed by insured; (4) a claim where fraudulent devices or means is used; (5) a claim which is honestly believed in when presented in the first place, but which the insured discovers subsequently that he suffers no loss or a loss smaller than that claimed for and yet decides to maintain and fail to correct his mistake.

---

[3] *Manifest Shipping Co Ltd v. Uni-Polaris Insurance Co.Ltd and La Reunion Europeene (The Star Sea)* [2001] 1 Lloyd's Rep.389

[4] [1927] 29 LI.L.Rep.141

[5] *Ibid.*, 145

[6] [2002] 2 Lloyd's Rep.42

Those five types of fraudulent insurance claims will be considered in details in the following sections. Nevertheless, the list is not exhaustive and one must keep an open mind throughout that it is surely the case that other types of insurance fraud may exist and if that is the case, then the references should be made to the discussions in Chapter One for the purpose of determining whether the situation could be treated as fraud.[7] In addition, a crystal clear line dividing those types of fraudulent claims may not be necessary because it will be demonstrated below that fraud committed in certain cases could certainly fall within more than one type of fraudulent claim identified above.

I. Wilful Fabrication of the Claim

[2.5] When there is a claim where the insured knows that he has not in fact suffered any loss, two possibilities may exist. First of all, the loss may actually be caused by the insured himself. For instance, a shipowner may scuttle his vessel and then make a claim against his hull insurer; or an owner of a property may set fire to his house and then seek the indemnity from his property insurer; The second possibility is that the insured may claim the loss of something which he never owned or possessed. For example, he may claim the loss of jewellery in an accident but in fact he never owned the jewellery. This type of fraud will usually be committed when the insured claims other genuine losses arising out of the same accident and the fraud may be regarded as an exaggeration of the claim which will be discussed in the next section. This section mainly focuses on the former kind of claim where the event leading to the loss is wilfully and intentionally caused by the insured.

[2.6] This kind of pure fraud probably would fit for the situation stipulated by Section 55 (1) and (2) (a) of Marine Insurance Act 1906, which states as follows: "(1)

[7] For instance, in the paragraph below at [2.44], in line with the principles established in the law of deceit (see Chapter One, at [1.16]), it has been held that fraud may be incurred if, after the submission of claim, the insured discovers the claim to be false or unfounded but nevertheless decides to maintain it. See the discussion in details at [2.44] and [2.45]

Subject to the provisions of this Act, and unless the policy otherwise provides, the insurer is liable for any loss proximately caused by a peril insured against, but, subject as aforesaid, he is not liable for any loss which is not proximately caused by a peril insured against. (2) In particular, (a) The insurer is not liable for any loss attributable to the wilful misconduct of the Assured, but, unless the policy otherwise provides, he is liable for any loss proximately caused by a peril insured, even though the loss would not have happened but for the misconduct or negligence of the master or crew."

The advantage for the insurer to plead that the fraud committed by insured is wilful misconduct is:[8] in addition to the remedies for fraudulent claims which will be discussed in Chapter Four in details, insurer can simply invoke the statutory remedy provided by Section 55 (2) which states that "the insurer is not liable for any loss attributable to the wilful misconduct of the assured".[9] Section 55 (2) entitles the innocent insurers to reject the particular claim tainted by fraud but does not go further to say anything on the validity of the policy, which actually accords with the current position of common law remedy with regard to fraudulent claims.[10] If the insurers want to discharge themselves from the insurance contract, they may need to further consider the availability of other remedies, e.g. contractual remedies.[11]

[2.7] Put compendiously, there are three reasons prohibiting the insured from recovering the losses from his wilful misconduct:

First of all, from the perspective of public policy, the maxim *dolus circuitu non purgatur*, or fraud unravels all, and *ex turpi causa non oritur*, the principle that no man can take advantage of his own wrong, has been widely accepted as underlying

---

[8] Eggers, PM & Picken, S& Foss, P, *Good Faith and Insurance Contracts*, 3rd edn, Lloyd' list (2010), 11.45

[9] It is suggested that it is not merely losses proximately caused by the wilful misconduct of assured cannot be claimed but also those more widely "attributed to" such misconduct. In other words, as long as wilful misconduct is one of the effective causes or factors contributing to a loss, the loss is irrecoverable. See *Trinder, Anderson & Co v Thamas & Mersey Marine Insurance Co* [1898] 2 QB 114. See also Dunt, J, *Marine Cargo Insurance*, Informa (2009), 8.39

[10] See Chapter Four, at [4.4]-[4.8]

[11] See Chapter Four, at [4.44]-[4.76]

the common law rule that insured's wilful act is a bar to recovery, and this reasoning seems to be the genesis of the first part of Section 55 (2) (a);[12] furthermore, in contrast to other provisions of Section 55, the first part of Section 55 (2) (a) is not prefaced with words "unless the policy otherwise provides", which means, it cannot be excluded by express stipulations in the policy.

Secondly, the essence of insurance is contingency, the sums are payable on the occurrence of an uncertain event.[13] If the insured can control the event, there is no insurance, so that recovery for self-induced loss is contrary to the nature of insurance.[14] In other words, there is no cover unless the insured event is accidental; if this condition is not expressed in the policy it will be implied, as Lord Atkin said that:[15]

---

[12] The second part of s.55 (2) (a) seems to come from the findings in the case of *Trinder Anderson & Co v. Thames ND Mersey Marine Insurance Company* [1898] 2 QB 114: the ship was run onto a reef because of the navigational negligence of the master and it was alleged by the underwriters in the appeal that the master could not recover under the policy since he was a part owner and one of the insured. The court held that the policy in question covered a loss proximately caused by a peril of the sea and that provided this was the proximate cause it did not matter if the loss was remotely caused by the negligent navigation of the master or crew or the owner himself, assuming that the loss is not occasioned by the wilful act of the assured.

[13] In *Prudential Inusrance v Commissioners of Inland Revenue* [1904] 2 KB 658, 663, Channell J said that insurance was a contract which bore a number of characteristics, *inter alia*, that "the event should be one which involves some amount of uncertainty. There must be either uncertainty whether the event will even happen or not, or if the event is one which must happen at some time there must be uncertainty as to the time at which it will happen".(Although this statement requires some modification in the case of life insurance which pays out either on the death of the insured or on the happening of an earlier event, i.e. the expiry of a given period of time, or, once the policy has run for a sufficiently lengthy period, the decision of the insured to surrender the policy for its accrued surrender value.)

[14] It is argued by Professor Clarke that it may be imprecise to say that it is in the very nature of insurance that it covers risks and not certainties and not therefore intentional loss or damage. Hence it is said, such loss is inherently uninsurable, because the loss is not a certainty until, at the earliest, and the intentional act is done. Clarke,M, *The Law of Insurance Contracts*, 6th edn, Informa (2009), 19-2E1

[15] *Beresford v Royal* [1938] AC 586, 604

> "An assured cannot by his own deliberate act cause the event upon which the insurance money is payable. The insurers have not agreed to pay on that happening. The fire assured cannot recover if he intentionally burns down his house, nor the marine assured if he scuttle his ship, nor the life assured if he deliberately ends his own life. This is not the result of public policy but of the correct construction of the contract."

Thirdly, as far as the causation issue is concerned, in a case where the loss is caused by wilful misconduct of the insured, it can hardly be recognized that the loss is caused by any insured peril, the claim of insured may therefore fail on the ground that there is no loss caused by any peril insured against. The result would be the same even when the wilful act of the insured is just one of the effective causes contributing to the loss.[16]

[2.8] The scope of this kind of pure fraud accords with the meaning of fraud in general that has been discussed in the Chapter One: it includes not only the actual intentional act of the insured but also contains the reckless act of the insured.[17]

In *Laceys Footwear (Wholesale) Ltd. v Bowler International Freight Ltd. and Another*, Beldam LJ made a summary of the precedents that: [18]

> "Few phrases have been more fully considered in decisions of the Courts than 'wilful misconduct'. The definition most usually adopted is that put forward by Lord Alverstone, C.J. in *Forder v. Great Western Railway Co.* [1905] 2 K.B. 532 where, with an addition, he adopted the definition of 'wilful misconduct' given by Mr. Justice Johnson in *Graham v. Belfast and Northern Counties Railway Co.*[1901] 2 I.R.13: 'wilful misconduct in such a special condition means misconduct to which the will is party as contradistinguished from accident, and is far beyond any negligence, even gross or culpable negligence, and involves that a person wilfully misconducts himself who knows and appreciates that it is wrong conduct on his part in the existing circumstances to do, or to fail or omit to do (as

[16] Gilman, J(Ed), *Arounld's Law of Marine Insurance and Average*, 17th edn, Sweet&Maxwell (2008), 22-07. See above, at [2.6], fn.9.

[17] Chapter One, at [1.17]-[1.29]. The insured in this context clearly means the insured personally, or his *alter ego* in the case of a corporate insured. In terms of the legal principles governing the way of determining the *alter ego*, see Chapter One, at [1.20]-[1.22]

[18] [1997] 2 Lloyd's Rep.369, 374

the case may be), a particular thing and yet intentionally does or fails or omits to do it, or persists in the act, failure or omission regardless of the consequences.' Lord Alverstone continued: 'the addition which I would suggest is, 'or acts with reckless carelessness, not caring what the results of his carelessness may be' "

As to the last point, Beldam LJ further explained that: [19]

"a person could be said to act with reckless carelessness towards goods in his care if, aware of a risk that they may be lost or damaged, he nevertheless deliberately goes ahead and takes the risk when it is unreasonable in all the circumstance for him to do so."

[2.9] In respect of the deliberate act of the insured, it seems not necessarily wrongful for the insured to destroy his own property. In this context, the purpose or intention of doing so is probably more significant than the conduct itself. Thus, it is suggested that wilful misconduct is committed if the insured intended to achieve a loss or damage and his immediate purpose is to claim on his insurers or that he subsequently advances such a claim.[20]

[2.10] However, the speech delivered by Beldam LJ above raises an interesting issue: whether it could be regarded as wilful misconduct has the owner deliberately taken a risk of loss or damage of which he is aware when it is unreasonable for him to do so? In the case of *Papadimitriou v Henderson*,[21] the vessel was captured on her voyage and a total loss was claimed from her war underwriters. The underwriters denied liability on the ground, *inter alia*, that the loss was caused by the wilful misconduct of the insured because he allowed the vessel to continue the voyage at a time when he and his agent well knew that her capture by the naval forces was imminent and the insured failed to take sufficient steps in due time or at all to prevent

---

[19] *Ibid.*

[20] *National Oilwell Ltd v Davy Offshore Ltd* [1993] 2 Lloyd's Rep 582, 622

[21] (1939) 64 Ll.L.Rep.345

the vessel from continuing her voyage or avert her loss by capture. Goddard LJ held that there was no misconduct by saying that:[22]

> "The fact was that the vessel was proceeding upon its chartered voyage. It continued to proceed along its chartered voyage. The owner was under no obligation that I know of to divert his vessel from that voyage unless, of course, she was obviously running into danger. He would not want to lose his ship, and no doubt he would give instructions to his captain if he could. The only definite warning that the owner had, or that anybody had, was that some trouble, that is to say, some search or stoppage for the purpose of search, might be expected off… I think it would be a very dangerous doctrine to lay down in the Courts of this country that the captain of a neutral ship or the owner of a neutral ship or the owner of a ship belonging to a country not at war, is guilty of wilful misconduct if he tries to proceed with his contract voyage, simply because there is a risk of capture, as there must always be a risk of capture during a war, which is the very reason why shipowners and merchants insure against war risks."

He further suggested[23] that the situation might be completely different if the shipowner received warning that a blockade had been established at a particular port, and he nevertheless deliberately sent his ship forward to that point to run the blockade, an inference might be drawn that he was not endeavoring to carry out the voyage, but what he was endeavoring to do was to get his ship captured, and that, of course, would be wilful misconduct. In this case, there was no evidence to show that the vessel might be captured where the incident took place, as a result of which, it might be concluded that the learned judge was of the opinion that the owner acted reasonably in the circumstances and so was not guilty of any misconduct.

[2.11] The second category of wilful misconduct of the insured, namely reckleness, is the case where the insured commits the unreasonable conduct involving a high probability of exposure the insured-subject to losses. That is to say, an insured who seemingly shows little interest in the safety of his property may be regarded as reckless indifference to the insured-subject and therefore be guilty of wilful

---

[22] *Ibid.*,348

[23] *Ibid.*,349

misconduct. An Australian case *Wood v Associated National Insurance Co Ltd*[24] is probably the best illustration in this regard. The owners of the vessel abandoned the vessel with inadequate and incompetent crew on board, and over the next few days, their only involvement was to increase the insurance cover on the vessel. During that period, the weather turned nasty and when the owners of the vessel knew from news reports that cyclonic winds were expected in that area, they did nothing but simply assumed that the inexperienced crew members would have abandoned ship. In fact, the crew had indeed abandoned the vessel, which subsequently broke anchor, stranded, and became a constructive total loss. The underwriters denied liability, not surprisingly in these circumstances, that the conduct of owners constituted the wilful misconduct within the terms of Section 61 (2) (a) of Australian Marine Insurance Act 1909, which is precisely identical to Section 55 (2) (a) of Marine Insurance Act 1906. The Supreme Court of Queensland, after analyzing English, American and Canadian authorities, provided the leading judgment on this point, which must be quoted as follows:[25]

> "Perhaps the most accurate general statement for present purpose of the conception underlying 'wilful misconduct' is that to be derived from the earlier case of Orient Insurance Company v Adams 123 US.67 (1887); that is to say, reckless exposure of the vessel to the perils of navigation knowing that she was not in a condition to encounter them. That raises a further question about the meaning of "recklessness". The word is capable of bearing a variety of shades of meaning depending upon matters such as the likelihood, and consequent foreseeability, of the risk materializing and the degree of attention that is given to that risk...a test of 'possible risks' may as a matter of authority be justified. However, in the present case the learned trial judge found that the loss of *Isothel* was a probable consequence of the plaintiffs' conduct in leaving her unskippered and with an incompetent crew in the circumstances and for the period for which they did...It follows that, whether the criterion adopted is foreseeability of 'possible' or 'probable' consequences, the requirement of recklessness is established by the findings in this case. It is certainly correct to say that the vessel was...exposed to perils of seas, her owners throughout knowing that she was no in a condition to encounter them and being indifferent to the risk that she would not survive those perils."

---

[24] [1985] 1 Qd R 297

[25] *Ibid.*, 305

Moreover, the court was of the view from the perspective of causation that the cause which was proximate in efficiency was the wilful misconduct rather than the perils of the sea:[26]

> "It was the wilful misconduct of the plaintiffs that exposed the *Isothel* to the perils of the seas when she was known not to be in a condition fit to encounter them. Once it became predictable that as a matter of probability she would encounter those perils and in her condition not be able to survive them, the element of chance or fortuity was eliminated or substantially reduced and her consequent loss became attributable to the owners' wilful misconduct and not to a peril insured against."

In short, the judgment of *Wood* case made a full explanation on the reckless behavior of insured in the context of wilful misconduct, with which will no doubt make the insurance industry delighted. The underwriters may have more chance to resort to the wilful misconduct defence of the Act. However, it should be borne in mind that the underwriter gained a lot of advantages from the factual background of *Wood* case, and they should not be too enthusiastic as there will be many cases where the neglect of the insured will not amount to reckless indifference which can bring the Section 55(2) (a) into operation.

[2.12] In the case of *The Michael*,[27] the owners insured their vessel *Michael* with the defendant Lloyd's underwriter under a standard marine policy which included, *inter alia*, loss by barratry. At a later stage, the vessel sank and became a total loss, and the owners claimed, *inter alia*, for loss by barratry. It was the common ground between the parties that the vessel had been deliberately sunk by Komiseris who was the office on watch when the vessel was sinking. The main issue was whether or not the vessel was deliberately sunk with the privity of her owners. Alternatively, the underwriters pleaded that the owner's initial claim for a loss by perils of the seas had been put forward fraudulently or recklessly on the ground that the owner then knew or strongly suspected that the vessel had in fact been deliberately sunk by Komiseris. Both the High Court and the Court of Appeal held that on the learned Judge's findings of fact,

---

[26] *Ibid.*, 308

[27] [1979] 1 Lloyd's Rep.55(First instance); [1979] 2 Lloyd's Rep.1(CA)

there was nothing to suggest that the owners had the knowledge of the sinking in advance and the claim had been fraudulently made. The argument made in this case has raised an interesting question as to the relationship between fraud of wilful misconduct and fraud of privity.

On the facts of the case, the reason that the wilful misconduct defence, which would usually be pleaded in the case of scuttling, was not raised was probably that this case was not a clear-cut situation of the involvement of owner's personal wilful or reckless act. The relevant point was just owner's knowledge as to the sinking of the vessel, which brought the concept of privity into the playground.

Privity is of course not mentioned in Section 55 (2) (a), but in one of the leading case with regard to the meaning of privity, *The Eurysthenes*,[28] Micheal Mustill QC (as he then was) raised an argument that "privity" in Section 39 (5) bears the same meaning of "wilful misconduct". This argument was rejected by the Court of Appeal. Lord Denning MR said that:[29]

> " 'Privity' did not mean that there was any wilful misconduct by him, but only that he knew of the act beforehand and concurred in it being done. Moreover, 'privity' did not mean that he personally did the act, but only that someone else did it and that he knowingly concurred in it."

Roskill LJ was of the same opinion: [30]

> "One asks why, if 'privity' means the same as wilful misconduct, the same language was not used both in s.39 (5) and in s.55 (2) (a)...In the context of the Act as a whole I think it is clear that 'privity' is not the same as 'wilful misconduct'. Nor is it the same as negligence or fault, whether personal or otherwise."

[2.13] Privity means with knowledge and consent. Knowledge for this purpose means not only positive knowledge but also the knowledge expressed in the phrase of

[28] [1976] 2 Lloyd's Rep.171

[29] *Ibid.*, 179

[30] *Ibid.*, 184

"turning a blind eye", and the latter point was considered further by the House of Lords in *The Star Sea*[31]. Lord Scott stated that: [32]

> "There must be a suspicion of the relevant unseaworthiness, and a decision not to check. Unless there is a decision not to check, not to obtain confirmation of what is suspected, there will, in my opinion, be no privity, no blind-eye knowledge, however seriously negligent the failure to check may be...In my opinion, in order for there to be blind-eye knowledge, the suspicion must be firmly grounded and targeted on specific facts. The deliberate decision must be a decision to avoid obtaining confirmation of facts in whose existence the individual has good reason to believe."

It could be seen from the Law Lords' views that the test for blind eye knowledge is a subjective one and privity has been defined in the context of deliberate decisions by the insured,[33] which is the same as wilful misconduct save that their Lordships did not mention recklessness in the judgment.

Although it seems legally comprehensible, both judgments, *The Star Sea* in particular, were criticized on the basis that they did not reflect the changing legal obligations on shipowners with regard to safety and seaworthiness and good practice in this regard which are well categorized by the implement of the ISM and ISPS code.[34] It is suggested that the Court of Appeal may not be absolutely right to declare free from hesitation that privity was not the same as wilful misconduct.

When commenting the case of scuttling and Section 55 (2) (a), the current editors of the leading textbook *Arounld's Law of Marine Insurance and Average* said that: [35]

> "The plainest application of the subsection is in cases where the assured has procured or connived at the deliberate casting away of the insured property, in order to recover on his insurance."

---

[31] [2001] 1 Lloyd's Rep.389

[32] *Ibid.*, [115]-[116]

[33] By analogy, in the light of deceit, where the defendant is guilty of deliberate wrongdoings and conceals or fails to disclose it in circumstances where it is unlikely to be discovered for some time, he may be considered as being fraudulent too. See Chapter One, at [1.25]

[34] See Hill, J, *Wilful Misconduct*, Chapter 7 of *The Modern Law of Marine Insurance : Volume 2*, Thomas, DR(Ed), LLP(2002), 7.12

[35] Gilman, J (Ed), *Arounld's Law of Marine Insurance and Average*, 17th edn, Sweet&Maxwell (2008), 22-35

More interesting analysis could be found at the footnote to this passage[36]:

> "There appears to be no reported case proceeding clearly on the ground that vessel was cast away with the connivance of the assured, but not at his instigation, but there can be no difference in principle between procurement and connivance. 'It is clear that consent or privity can range from active complicity to mere passive concurrence. An owner who makes it clear that he would like to see his ship at the bottom of the sea, but does not want to know any more about it, is privy to its sinking in just the same way as Henry II was privy to the murder of Thomas a Becket when he said: 'will no one rid me of this turbulent priest?' Even if the suggestion of scuttling comes from someone else and the owner implies consent by saying nothing against it, he would be privy', per Kerr J, in *The Michael* [1979] 1 Lloyd's Rep.55, 66; affirmed in the Court of Appeal [1979] 2 Lloyd's Rep.1. Moreover, if the assured so to speak ratifies the casting away of his vessel and presents the claim on a basis which he knows to be false, this is a fraudulent claim and cannot, as such, be recovered."

Therefore, it is submitted that in theory privity in certain circumstance, e.g. privity committed seriously that exposes an insured in the spotlight who seemingly shows little interest in the safety of his property, may have intersections with the concept of wilful misconduct at least in the sense of recklessness and therefore being capable of being pleaded as fraud. Any claim submitted on this basis could be regarded as fraudulent claim accordingly. [37]

II. Exaggeration of the Claim

[2.14] Making an opportunistic exaggeration of the amount of loss is considered by the underwriters perhaps not only as the most common variety of fraudulent or

---

[36] *Ibid*, fn.331

[37] It is noteworthy that in *The Michael*, both the High Court and the Court of Appeal did not question the basis of pleading the possible knowledge and consent of the owner as fraudulent claim-the plea failed on its facts, which may indicate it indeed is possible to argue the case from this point of view.

dishonest claim, but also the most difficult one to discern. As a research conducted by Insurance Australia Group (IAG) indicates that: [38]

> "The exaggeration of genuine personal lines insurance claims, such as vehicle and household insurance is believed to be the most common type of fraud. It is also the hardest to detect. Not only do personal insurance products generate a large number of small-value claims, making it tough for insurance companies to investigate all but the most spurious, but it can be difficult to differentiate between the genuine and the fabricated elements of an exaggerated claim. Large claims on commercial insurance products, by contrast, are likely to attract the attention of fraud investigators, making such a deceit more risky and more difficult to perpetrate."

There are numerous reasons triggering the insured to inflate an otherwise legitimate claim, most of which seem to be pecuniary: the insured may be seeking to make a profit from his loss; he may be presenting a "bargaining" claim in the belief that underwriter will cut it down and the ultimate compromise agreement will approximately represent his actual loss; or he may indeed genuinely have overestimated the value of his property by including an element for consequential loss not covered by the policy which he may not really understand.[39]

Some of the reasons listed above seem not legally reprehensible and exaggeration does not necessarily amount to fraud. Accordingly, the question arises as to what degree of exaggeration will make the claim fraudulent.

A. Exaggeration must be substantial

(a) The meaning of substantiality

[2.15] In a very early case of *Goulstone v Royal Insurance Company*,[40] a fraudulent claim was defined as a claim which is "willfully false in any substantial respect",[41] and there is no reason why this quotation should not be applied in exaggeration

---

[38] Insurance Group Australia, *Hidden Cost* (2004), 3, available at http://www.iag.com.au/, accessed on 6th April 2012.

[39] Merkin, R, *Colinvaus's Law of Insurance*, 8th edn, Sweet&Maxwell (2006), 9-22

[40] (1858) 1 F&F 276

[41] *Ibid.*, 279

situations. Similar discussion could also be found in *Lek v Mathews*,[42] where the insured had exaggerated a genuine loss as a result of the theft of a stamp collection, by including a claim relating to stamps he did not possess. The policy contained a clause to the effect that it was avoided if a false claim was made and Viscount Summer considered the clause as applicable to "anything falsely claimed, this is anything not so insubstantial as to make the maxim *de minimis* applicable, and it is not limited a claim which as to the whole is false."[43]

[2.16] Two principles might be drawn from the above two cases: firstly, a claim need not be wholly false to be fraudulent; secondly, there is a *de minimis* principle in play in cases of fraudulent exaggeration claims. Again, in *Orakpo v Barclays Insurance Services*,[44] Hoffmann LJ classified a claim as fraudulent if it is "substantially fraudulent" and Sir Roger Parker held that a claim is fraudulent if "fraudulent to a substantial extent". However, all these cases provided no direct guide on the method of determining what is substantial, until Millet LJ expressed his opinion in *Galloway v Guardian Royal Exchange.*[45]

In this case, the insured had a genuine claim for a burglary for £16,000 but he had intentionally increased the amount for a loss of a computer which he never actually had but he valued at £2,000. In the first place, Lord Woolf MR considered the question as a mathematical one in the sense that "one must look at the whole of the claim…The part which is fraudulent …is 10% of the whole. That is the amount which is substantial and taints the whole.[46] Millet LJ agreed but added his own comment and rejected the submission that substantiality should be tested by reference to the proportion of the entire claim which is represented by the fraudulent claim, as this would lead to "the absurd conclusion that the greater the genuine loss, the larger the

[42] [1927] Ll.L.Rep.141

[43] *Ibid.*, 145

[44] [1995] LRLR 443

[45] [1999] Lloyd's Rep.IR 209

[46] *Ibid.*, 213

fraudulent claim which may be made at the same time without penalty."[47] His Lordship suggested that:[48]

> "The right approach in such case is to consider the fraudulent claim as if it were the only claim and then to consider whether, taken in isolation, the making of that claim by the insured is sufficiently serious to justify stigmatizing it as a breach of his duty of good faith so as to avoid the policy."

This "isolation" approach rather than "proportion" approach was supported by Mance LJ in a later case *Agapitos v Agnew*,[49] where his Lordship held that for the purpose of invoking fraudulent claim rule, the fraud should relate to "a part of the claim which, when viewed discretely, is not itself immaterial or unsubstantial."[50]

[2.17] In order to better understand the meaning of substantiality, a comparison shall be made with the approach taken by Australia insurance contract law.[51] In the report which was conducted by Australian Law Reform Commission that provided a detailed analysis of the adequacy and appropriateness of the common law principles and the statues governing insurance contracts (ALRC 20 on Insurance Contract), the question was raised as to whether insurer would, in practice, totally reject a substantial claim merely because the insured had acted fraudulently in relation to a minor part of the claim. In the report, the Commission used the example that a claim for $3,000 lost baggage would usually be met even if a fraudulent claim that a $200 camera was included in that baggage was rejected. This led to the recommendation and finally the legislation that in the proceedings in relation to a fraudulent claim: the court may, if only a minimal or insignificant part of the claim is made fraudulently

---

[47] *Ibid.*, 214

[48] *Ibid.*

[49] [2002] 2 Lloyd's Rep 42, 50

[50] *Ibid.*

[51] The English and Scottish Law Commissions, when conducting the inquiry into reform of the UK law on insurance contracts, have paid close attentions to Australia's Insurance Contract Act 1984 as well as the content of Australian Law Reform Commission's report on Insurance Contract (AIRC 20). These documents address many of the issues that the two Commissions are considering in the British context. See generally, The Hon.Michael Kirby AC CMG, *Australian Insurance Contracts Law: Local Reform with a Global Relevance*, [2011] JBL 309

and non-payment of the reminder of the claim would be harsh and unfair, order the insurer to pay such amount in respect of the claim as the court considered just and equitable in the circumstances. In exercising its discretion, the court would be required to have regard to all relevant factors including the general need to deter fraud.[52] It was further suggested in the Explanatory memorandum accompanying the Insurance Contracts Bill 1984 that it would be unfair for an insured to have the whole of a legitimate claim for the loss of contents worth $100,000 disallowed merely because he fraudulently claimed for the loss of non-existent watch worth $ 50.

Section 56 (2) was tested in the case of *Entwells Pty Ltd v National and General Insurance Co Ltd.*[53] The insured, by inserting fictitious items into stock list, intentionally inflated stock values to losses suffered in a supermarket fire by approximately $27,000 out of a total claim worth as much as $528,000. The court held that the knowingly inflated part was "relatively" small and non-payment of the entire claim would be harsh and unfair. It was the view of the court that it would be more appropriate to disallow the insured's claim for loss of stock completely (which valued $94,000 altogether) but permit the insured to recover the rest of the loss.

However, there may still be some difficulties in applying this section practically. On a conceptual level, it is difficult to reconcile with Sections 12 and 13 of Insurance Contracts Act 1984 whereby the duty of utmost good faith clearly has paramount effect which "is not limited or restricted in any way by any other law, including the subsequent provisions of this Act". Any fraud, no matter how small in quantum, is crystal clear to be an offence of duty of utmost good faith at least in a conceptual sense. In addition, on a pragmatic level, the opposition voice points out that: [54]

> "The provision presupposes that it is possible to dissect the claim which is made fraudulently so as to be able to determine that some part of it only involved fraudulent conduct. That part must be minimal or insignificant. It is difficult to see how it could be suggest that there was only a little fraud. It seems akin to describing someone as being only a little pregnant."

[52] ALRC 20, [243]; Section 56 (2) (3) of Insurance Contract Act 1984

[53] (1991) 6 WAR 68

[54] Marks, F, & Balla, A, *Guidebook to Insurance Law in Australia*, 2nd edn, Norty Ryde(1987), 334

The example provided by Attorney-General can indeed be justified but it is far beyond the reality as it does not make any sense that the insured will commit exaggeration even less than three figures. The exaggeration committed by the insured in the case of *Entwells*, if decided in the jurisdiction of UK in the eyes of *Galloway*, will probably be treated as fraudulent because $27,000, considered in isolation, would be sufficiently substantial to be labeled as fraud.

[2.18] Accordingly, it is suggested that the loose approach adopted by Australia may not be appropriate and also may cause uncertainties in judicial practice. A little white lie might be overlooked, but it seems that the strict approach adopted by UK legal system which is directed to deterring and discouraging false claims might be more feasible and workable. The philosophy behind the strictness was summarized by Millet LJ in the case of *Galloway*: [55]

> "The making of dishonest insurance claim has become all too common. There seems to be a widespread belief that insurance companies are fair game, and that defrauding them is not morally reprehensible. The rule which we are asked to enforce today may appear to some to be harsh, but it is in my opinion a necessary and salutary rule which deserves to be better known by the public. I for my part would be most unwilling to dilute it in any way."

(b) The difference between "substantiality" and "materiality"

[2.19] It seems slightly confusing that the learned judges used the words "material" and "substantial" in an interchangeable fashion. "Material" or "Materiality" is a more technical word in the realm of insurance law, which, according to Section 18 of Marine Insurance Act 1906 and the decision of the House of Lords in the case of *Pan Altantic Ins Co v Pine Top Ins.Co*[56], indicates a relationship between the fraud made by the insured and the decision of the underwriter to take the risk or to take it at a different premium. For example, in *The Litsion Pride*,[57] Hirst J linked the concept of materiality with fraud by saying that: "...Consequently, I hold that any fraudulent

[55] [1999] Lloyd's Rep.IR 209, 214.

[56] [1995] 1 AC 501

[57] [1985] 1 Lloyd's Rep.437, 513

statement which would influence a prudent underwriter's decision to accept, reject or compromise the claim, is material." In *Agapitos v Agnew*,[58] when considering whether the fraud needs to have any effect on the insurer's conduct, Mance LJ clearly indicated that for non-existent or exaggerated loss,[59] once a fraudulent claim is established, whether or not insurers are misled should not matter at all. In other words, there is no additional test of materiality being built into the concept of those types of fraudulent claims.[60]

However, different opinion seemingly emerged in *Danepoint Ltd v Underwriting Insurance Ltd*,[61] where an insured claimed for loss of rent in relation to a property divided up into 13 flats, each of which had been sublet to various tenants. The insured claimed that all flats had been vacated following a fire at the property and the loss of rent claim was based on all of the flats being unoccupied, which was untrue. HHJ Coulson QC held that the claim for loss of rent was inflated and claim was fraudulent, but it is the reasoning he gave that triggered controversy. He said that an exaggerated claim would be categorized as fraudulent if, *inter alia*, the fraud has a decisive effect on the readiness of the insurers to make payment. It is this conclusion that makes the concept of materiality (and inducement) connected with fraudulent claims.

The judgement made by HHJ Coulson QC is open to serious criticize on several grounds:[62] First of all, when coming to the "decisive effect" conclusion, the learned judge relied heavily upon a South African case of *Guardian Royal Exchange v Ormsby*.[63] Fraud in that case, which consisted of supplying photographs that included damage inflicted after the relevant event, was held not to be material because the insurer would have paid the same amount anyway. However, this conduct would in any view be regarded a fraudulent device for promoting a claim if decided today in UK's jurisdiction. HHJ Coulson QC realized this position but nevertheless decided to

[58] [2002] 2 Lloyd's Rep 42, 51

[59] The fraud committed by using the fraudulent devices or means might be another story, which will be analyzed in details below, at [2.28]

[60] *Royal Boskalis Westminster NV v Mountain* [1997] LRLR 523, 599 (Rix J)

[61] [2006] Lloyd's Rep.IR.429

[62] See Gilman, J(Ed), *Arnould's Law of Marine Insurance and Average*, 17th edn, Sweet&Maxwell(2008), 18-71

[63] [1982] 29 SASR 498

follow it.[64] Secondly, In *Stemson v AMP General Insurance (NZ)*,[65] the decision of Privy Council put severe doubt on the correctness of decision of HHJ Coulson QC. Their Lordships confirmed that the making of false statements even in support of a genuine claim meant that the insured had used fraudulent means or devices to promote the claim. The fact that the lie was detected or unraveled before a settlement or during a trial did not render the lie immaterial.

Accordingly, in the situation of exaggeration, as long as the figure inflated is substantial pursuant to the judgement of *Galloway*, the concept of materiality (inducement) has no ground to play. The decisions in the case of *Danepoint* should not be followed.

B. Figures for negotiation is not usually fraudulent

[2.20] In *Orakpo v Barclays Insurance Services*,[66] it is judicially recognized that inflated figures for negotiation should usually not be treated as fraudulent. Hoffman LJ, with whom Sir Roger Parker agreed, said that:[67]

> "One should naturally not readily infer fraud from the fact that the insured has made a doubtful or even exaggerated claim. In cases where nothing is misrepresented or concealed, and the loss adjuster is in as good a position to form a view of the validity or value of the claim as the insured, it will be a legitimate reason that the assured was merely putting forward a starting figure for negotiation."

Staughton LJ expressed the same opinion:[68]

> "Some people put forward inflated claims for the purpose of negotiation, knowing that they will be cut down by an adjuster. If one examined a sample of insurance claims on household contents, I doubt if one would find many which stated the loss with absolute truth. From time to time claims are patently exaggerated; for example, by claiming the replacement cost of chattels, when only the depreciated value is insured. In such a case, it

[64] [2006] Lloyd's Rep.IR.429, 437, [51]

[65] [2006] UKPC 30

[66] [1995] LRLR 443

[67] *Ibid.*, 451

[68] *Ibid.*, 450

may perhaps be said that there is in truth no false representation, since the falsity of what is stated is readily apparent. I would not condone falsehood of any kind in an insurance claim. But in any event I consider that the gross exaggeration in this case went beyond what can be condoned or overlooked. Nor was it so obviously false on its face as not to amount to a misrepresentation."

[2.21] Similarly, in *Nsubuga v Commercial Union Assurance Co plc*,[69] a bulk of retail stock was damaged in a fire at shop premises, the insurers accepted as genuine the submission of one claim for stock damaged or partly damaged by the fire in the sum of £10000 but there were second and third claim with an exaggeration value of £10000. The insurers argued that that these claims were fraudulent and the court found no difficult to determine there was fraud with regard to the second and third one. Thomas J commented that: [70]

> "However, it is important to stress that in connection with this way of putting the claim it is my view that very clear evidence of fraud would be required because one has to accept as a matter of commercial reality that people will often put forward a claim that is more than they believe that they will recover. That is because they expect to engage in some form of "horse trading" or other negotiation. It would not generally in those circumstances be right to conclude readily that someone had behaved fraudulently merely because he put forward an amount greater than that which he reasonably believed he would recover. He would have to put forward a claim that was so far exaggerated that he knew that in respect of a material part of it, there was no basis whatsoever for the claim."

Thus, it seems if the claim is knowingly inflated by the insured for the purpose of negotiation, or as a bargaining device, the claim may not be considered as being fraudulent, particularly in a case where the insurer's loss adjuster is in as good a position to the value the claim as the insured or he has a clear opportunity to exercise careful scrutiny before any payments are authorized.

[2.22] In addition, where the valuation of the subject matter of the claim is difficult to ascertain, it also seems reasonable not to infer fraud regardless of overvaluation.

[69] [1998] 2 Lloyd's Rep.682

[70] *Ibid.*, 686

This position was illustrated in an Australia case *Dawson v Monarch Insurance Co of NZ Ltd.*[71] The insured claimed $6,000 under the policy for the total loss of an inflatable rabbit which was unique and consequently its value was difficult to assess. At that time there was no ready market for inflatable rabbit. The learned judge was of the opinion that an exaggeration could not be intentional if the insured did not know of the true value of the insured property, and he thought this case was in this situation. Thus, he ordered the insurer to pay $3,500 in respect of the rabbit.

C. The limitation of the concept of "figures for negotiation"

[2.23] First of all, in some cases where the amount of the claim is greatly exaggerated it may justify the inference that the claim is not honestly made and in such a case the exaggeration is probably fraudulent. In *Pogo Holding Co v New York Property Insurance Underwriting Association*,[72] the insured claimed the loss caused by fire damages under a policy of fire insurance. He valued the loss at a figure approximately five times greater than the value set by the insurer's adjuster and the price of the property when purchased by the insured two years earlier. The court, when taken with other evidence, was of the opinion that there was positively excessive valuation which was sufficient to constitute a fraud. Although this is an American case, there is no reason for English authorities to deviate from. In *Transthene Packing Co.Ltd v Royal Insurance Ltd*,[73] the insured advanced a claim for the full replacement cost of a lost machine but HHJ Kershaw QC held that "to claim the full replacement cost under a fire policy in respect of a machine which was so defective before the fire as to be likely the subject of litigation against the manufacturer or supplier is fraud."[74] Accordingly, in *Ewer v National Employers' Mutual General Insurance Association Ltd*,[75] the insured submitted his claim based on the new replacement cost of his goods, whereas he was only entitled to recover their second hand value. Mckinnon J recognized that the claim was "preposterously

[71] [1977] 1 NZLR.372

[72] 467 N.Y. S.2d 872 (1983)

[73] [1996] LRLR 32

[74] *Ibid.*, 44

[75] [1937] 2 ALL ER.193

extravagant" but rejected the argument that the claim was fraudulent. If decided today, it seems very unlikely indeed that a claim which is described as "preposterously extravagant" would now be found not to be fraudulent on the basis that it simply reflected a bargaining position.

[2.24] Secondly, when putting the figures on the table, there must be some reasonable basis. "Exaggeration which is willful, or which is allied to misrepresentation or concealment will, in all probability, be fraudulent."[76] In *Dome Mining Corp v Drysdale*,[77] the insured submitted a claim as a total loss for his damaged dredger, and an engineer's report was produced to support the claim. The Court found that (a) the insured did not have any honest belief that the dredger was so badly damaged as to be a total loss; and (b) the engineer's report expressed an opinion the insured did not believe the engineer held, which made the report equivalent to false evidence.[78] In short, if the claim is inflated "beyond the bounds of any genuine estimate",[79] it is possible that the courts may regard the case as an appropriate one to infer fraud.

[2.25] In conclusion, it is submitted that a crystal clear dividing line between the exaggeration for negotiation purpose and for fraudulent purpose may not be easy to draw. The surrounding circumstances of the particular case remain everything. As it is suggested in Chapter One, a dishonest mind must be found and the wickedness must be presented in the context, and the clues mentioned above may be helpful in this regard.

---

[76] *Danepoint Limited v Underwriting Insurance Limited* [2006] Lloyd's Rep.IR.429, 438

[77] (1931) 41 Ll.L.Rep.109

[78] It is in the opinion of the author of this thesis that today the case would be likely to be decided on the ground of using fraudulent devices

[79] *Connolly Ltd v Bellway Homes Ltd* [2007] EWHC 895 (Ch), [137] (Stephen Smith QC)

III. The Use of Fraudulent Devices or Means

A. The meaning of fraudulent devices or means and the appropriate tests

[2.26] Sometimes, even if the insured suffers a genuine loss which is caused by insured perils, he may not feel confident that the loss will be indemnified, and for the purpose of promoting his claim, a lie might be advanced or a fraudulent document might be used in support of the claim. Insurers may be entitled to treat such kind of claims as fraudulent claims too.

[2.27] In an early case *Wisenthal v World Auxilliary Insurance Corp Ltd*,[80] a stock of furs was stolen from warehouse, the insurers denied their liabilities on the basis that there had been a deliberate concealment of material documents and facts in the value of claim, including a stock book and the existence of a particular bank account. Roche J commented that: [81]

> "Fraud was not mere lying. It was seeking to obtain an advantage, generally monetary, or to put someone else at a disadvantage by lies and deceit. It would be sufficient to come within the definition of fraud if the jury thought that in the investigation deceit had been used to secure easier or quicker payment of the money than would have been obtained if the truth had been told."

Similarly in *The Litsion Pride*,[82] the court gave the judgment in favor of the underwriter and rejected the argument that the fraudulent claim principle was limited to fraud going to claims *per se*, finding on the evidence that the shipowners had sought to support their claims with fraudulent documents, namely, the purportedly backdated letter.

---

[80] (1930) 38 Ll.L.Rep.54

[81] *Ibid.*, [62]

[82] [1985] 1 Lloyd's Rep.437. The details of this case are discussed further in Chapter Four, at [4.81]-[4.85]

[2.28] The points were picked up directly and explicitly in *Agapitos v Agnew*.[83] In this case, the insured vessel was insured against hull risks which contained a warranty that there would be no hot work on the vessel. The insured wished to carry out refurbishment works and so the insurers agreed to the works on the condition (actually a new warranty) that the works be approved by their surveyors. A fax was subsequently sent by the vessel's managers indicating that the hot works had been started. The vessel caught fire during the hot work, which was a breach of warranty as no surveyor had certified the carrying out of the hot works. The insured denied that warranty had been breached by alleging that the hot works had been commenced on 12/02/1996 and in so far as there was any breach of warranty, the failure of the designated surveyor to make himself available prior to the commencement of the hot works constituted a change of circumstance which excused the non-compliance. However, the hot works had in fact been commenced on 01/02/1996 which was confirmed by two workmen in witness statements in the proceedings. The insurers submitted the application to amend their defence to plead fraud on the basis that the insured had falsely and fraudulently misrepresented that the date of the commencement of the hot works. Although the pleading failed on grounds that the duty of utmost good faith[84] or a common law duty ends after the commencement of proceedings at least as regards the claim in question, Mance LJ took the opportunity to consider what constitutes the fraudulent device by saying that: [85]

> "A fraudulent device is used if the insured believes that he has suffered the loss claimed, but seeks to improve or embellish the facts surrounding the claim, by some lie...My tentative view of an acceptable solution would be...(c)To treat as relevant for this purpose any lie, directly related to the claim to which the fraudulent device relates, which is intended to improve the insured's prospects of obtaining a settlement or winning the case, and which would, if believed, tend, objectively, prior to any final determination at trial of the parties' rights, to yield a not insignificant improvement in the insured's prospects, whether they be prospects of obtaining a settlement, or a better settlement, or of winning at trial "

---

[83] [2002] 2 Lloyd's Rep.42

[84] *The Star Sea* [2001] 1 Lloyd's Rep.389

[85] [2002] 2 Lloyd's Rep.42, [30] and [45]

It can be summarized from the speeches of Mance LJ that not every false statement made by the insured in support of his claim will be regarded as fraudulent. Three preconditions need to be satisfied before fraud can be established: (a) the lie must be directly related to the claim. In other words, it is vital to establish a causal link between the fraud and the claim. For instance, where the owners of insured goods forged a certificate of inspection to substantiate their title to the goods, the insurer may not be entitled to deny liabilities;[86] (b) the subjective mental element of the insured to promote the claim is needed; (c) the lie should be material[87] in the sense that if it is believed, it could bring significant improvement of the prospect of insured's case. In other words, the irrelevant lies which would have no significant impact whatsoever on the mind of insurer or judge should be excluded. Assuming a case where the insured makes false statement as to the circumstances of the loss not because he wants to embellish his claim but he does not wish to admit the real cause of the loss by reason of embarrassment, it is arguable that the condition (b), possibly also (c) could be satisfied and, therefore, no fraud is committed.[88] It should also be noticed that once a lie satisfies the conditions listed above, no further requirement of inducement is needed in the light of the comments of Mance LJ.

[2.29] Mance LJ laid down the general principles in this regard but many uncertainties still remain. Most comments that Mance LJ made were *obiter* while the *ratio* of *Agapitos* dealt with a breach of duty of good faith after litigation had commenced. In *Interpart Comerciao e Gestaao SA v Lexington Insurance*[89], the insured submitted a claim under a cargo policy, having relied upon a false dated certificate of inspection in support of its claim. The Court accepted the arguments raised by the insurers that (1) the fraudulent inspection certificate had been used as a part of the documentation that founded the insured's claim; and (2) the general principle that the fraud was not required to have any inducing effect on the insurers,

[86] *Interpart Comerciao e Gestaao SA v Lexington Insurance* [2004] Lloyd's Rep.IR.690

[87] *Cf.*, [2.19]

[88] Merkin, R, *Colinvaus's Law of Insurance*, 8th edn, Sweet&Maxwell (2006), 9-25

[89] [2004] Lloyd's Rep.IR.690

but HHJ Chambers QC declined to grant summary judgment[90] for the underwriter. He was of the opinion that the law on the promotion of claims by fraudulent means was "uncertain" and in a state of development, in particular, the degree of nexus that there has to be between the fraudulent conduct and the promotion of the claim against insurer was unclear: "It is not yet established how close must be the relationship between the fraud relied upon and the claim". Similarly, in *Marc Rich Agriculture Trading SA v Fortis Corporate Insurance NV*,[91] Cooke J refused to strike out a defence by insurers who pleaded that insured had deliberately concealed what were described as material facts, with the intention of obtaining a not insignificant improvement in his prospects of receiving the indemnity by not disclosing facts which might give rise to a defence to the claim, he referred to this area of law being "undoubtedly a difficult, contentious and developing area of law".[92]

[2.30] Nevertheless, a few decided cases in the last decade can be found as examples of the application of the principle considered in *Agapitos v Agnew.*

In *The Game Boy*,[93] The vessel in question was insured by the claimant under a marine hull policy at a value of $1,800,000. After the suffering of loss, the insured brought the claim but the insurers argued that the insured had made material misrepresentations about the condition and value of the vessel, and in particular that the vessel's true value was significantly less than the value of $1,800,000 in the insurance contract. The insurers also submitted that in order to support that value, and as part of the fraudulent presentation of the claim, the defendants arranged for a number of false documents to be created; even if the defendants had a valid claim, the claim had to fail because the defendants had used fraudulent devices to promote the claim. The Court held that the insured had used fraudulent devices in order to advance the claim, with the intention and expectation that the insurers would accept the

[90] In the case of seeking summary judgment, the task of the Court is not to produce a definitive view of the law, but merely to ascertain whether the claimants under the circumstances had a prospect of success

[91] [2005] Lloyd's Rep.IR.396

[92] *Ibid.*, [33]

[93] [2004] 1 Lloyd's Rep.238

documents, be reassured and promptly pay the insured. Accordingly, the insurer was discharged from liability for the claim.[94]

In *Stemson v AMP General Insurance (NZ) Ltd*,[95] the insured's building was damaged by fire. The insurers refused to indemnify on the grounds that (a) the fire had been deliberately started; (b) a fraudulent claim was submitted by the insured because the insured had told the insurers' claims investigator that he had never had an intention of selling the building when he had made surreptitious abortive attempts to do so due to his straitened financial position shortly before the fire. The statement had been corrected before the insurers made the decision to reject the claim. The insurers won the case on both grounds in the Privy Council. Their Lordships (Lord Mance being a member of the Board) confirmed the insured did indeed use fraudulent devices in support of his claim and specifically endorsed the statements by Mance LJ in *Agapitos v Agnew* with no hesitation and held the fact that the lie had been corrected months before the claim was rejected did not make it immaterial at the time it was told. The insurers were thus under no liability for this independent reason.

[2.31] For the purpose of comparison, it seems that Australia shares the same attitude towards the fraud committed by using fraudulent devices or means. In the leading case *Tiep Thi To v Australian Associated Motor Insurer Ltd*,[96] the insured's car was involved in an accident because her son who was only 15 drove the car without her approval. After discovering the damages, the insured moved that car a short distance and reported to the police three days later that the car had been stolen and damaged possibly by a gang of youths. When she claimed upon the insurance policy subsequently, she repeated the false story because she was worried that the policy did not cover the damages caused by being driven by an unlicensed person without the insured's consent (but it turned out that the insured mistakenly construed

[94] *Ibid.*, [153]-[154]

[95] [2006] Lloyd's Rep.IR.852

[96] [2001] 161 FLR 61

the contents of policy). The Court ruled in favour of the underwriter that the insured was not entitled to recover. Buchanan JA said that: [97]

> "The existence of an underlying valid claim does not render fraud irrelevant; the dishonest intention required for fraud is at least one to induce a false belief in the insurer for the purpose of obtaining payment or some other benefit under the policy, with or without belief or knowledge of a lack of entitlement; and fraud which relates to the claim made with the requisite intent will disentitle the claimant even if made subsequent to the first presentation of the claim."

B. The recent development of case law

[2.32] Notably, within the last three years in particular, the insurers are more and more inclined to invoke the use of fraudulent devices or means as their defence. The judicial world is also seemingly enthusiastic not to identify a claim supported by fraudulent evidence, devices or means as being a valid claim if the preconditions set out by Mance LJ are met. A series of very recent High Court decisions has been reported and deserves more attention in the following paragraphs.

[2.33] The first case is *Direct Line Insurance Plc v Fox.*[98] The defendant Mr Fox entered into an insurance contract, which contained a typical fraudulent claim clause, with the claimant insurer for his buildings and contents thereof against the damages caused by smoke and fire. A claim was submitted later after a fire happened in the kitchen of the building and the insurer accepted the claim. Both parties reached a writing agreement whereby the insured had accepted a fixed sum in full and final settlement of his claim. This compromise agreement provided that insurer shall make an interim payment and then a final VAT payment, which was subject to a condition precedent that Mr Fox must provide an invoice from a company that was supposed to carry out the repair work of the kitchen. The interim payment was made and Mr Fox then provided an invoice for the VAT element which was purportedly from the company that actually did not proceed with the repair work. Although when the

[97] *Ibid.*, 66

[98] [2009] EWHC 386 (QB)

insurer was inquiring the authenticity of the invoice, Mr Fox retracted his submission of the invoice, saying that he no longer wished to pursue the VAT element of the claim, the insurer nevertheless brought the proceedings against him for the purpose of recovering the sums already paid on the basis that the fraudulent claim clause in the insurance contract has been breached due to the fact that Mr Fox had used a fraudulent invoice.

The main defence submitted by the barrister acting on behalf of Mr Fox was that Mr Fox had not sought to advance a fraudulent claim under the policy but had rather sought to use the misleading document to satisfy the condition precedent to the payment under the compromise agreement that was distinct from the insurance contract, thus fraudulent claim clause in the insurance contract was not applicable.

The court favoured this submission and held that when a claim is compromised, that compromise gives rise to a new cause of action which either discharges or modifies the contract in relation to which the claim is said to have arisen. Although Mr Fox had been dishonest in submitting the false invoice, he did not intend to establish an element of claim under the policy but intend to fulfill the precondition set out in the compromise agreement for the purpose of getting the final payment. The compromise was a separate contract rather than a mechanism of quantification of the loss under the original insurance contract. Therefore, the rules set out by Mance LJ in the case of *Agapitos v Agnew* had no room to apply, the fraudulent claim clause was not applicable and the dishonest attempt of Mr Fox to assert that precondition had been satisfied did not have the result that he had to repay to the insurer all of the sums paid to him in respect of his claims for indemnity against the losses sustained by him as a result of the fire and smoke. The significance of this decision could be that it is now clearer as to the scope of duty of utmost good faith that the duty not only ends once litigation between the insurer and insured commences but also ends at the moment at which the parties enter into a binding compromise settlement contract.

The court also considered, *obiter*, the effect of Mr Fox's intention to retract his submission of the false invoice. The second line of Mr Fox's defence was that even if the agreement was a mechanism of quantification of the loss under the original insurance contract, then in order to avoid loss of the claim, Mr Fox's retraction of the fraudulent invoice was possible. The court admitted that currently there is no judicial

authority on this point. The origin of this argument is possibly from Professor Rhidian Thomas' article where he wrote that:[99]

> "there is also a distinct moral difference between the position of a fraudulent claimant and a fraudulent claimant who retracts before the claim is considered by the insurer or settlement, particularly where the retraction manifests repentance rather than strategic advantage…it is suggested that the law in its development should recognize this difference and encourage honesty by recognizing the effectiveness of a genuine retraction."

After reviewing a series of judicial authorities, the court concluded that there is no part of English law that the consequences of the rule concerning fraudulent claims can be mitigated in the case of retraction. Retraction could only be material in the cases in which the fraudulent insured retracted voluntarily and sufficiently early before the insurer has casted any suspicions as to the validity of the claim or the relevant element in it. The submission that retraction should be possible at any stage prior to the insurer declining the claim in question would be too wide, because "it would set a premium on a fraudulent insured guessing how long it would take the insurer to assemble evidence which would justify declining cover, so as to be able to retract, if necessary, before the insurer had assembled the necessary evidence." [100]

[2.34] The second case is *Yeganeh v Zurich Insurance Co.*[101] The case has not raised discussion on any substantive legal point. The debate focused upon the role of evidence: The claimant insured entered into an insurance contract covering the losses and damages to the buildings and the contents thereof with the defendant insurer. The insured subject-matter was seriously damaged in an accidental fire (this was challenged by the insurer but the burden of proof on its part was not discharged[102]) and the claimant sought to recover the indemnity from the defendant. A list of contents that were damaged in the fire was submitted to the insurer which included a

---

[99] Thomas, DR, *Fraudulent Insurance Claims: definition, consequences and limitations* [2006] LMCLQ 485, 497

[100] [2009] EWHC 386 (QB), [44]

[101] [2010] EWHC 1185 (QB) (High Court); [2011] EWCA Civ.398 (Court of Appeal)

[102] See the discussion relating to the burden of proof in Chapter Three, at [3.7]

number of expensive items of clothing. However, insurer's expert could hardly find the trace of any of those claimed high-value clothing during the inspection of the property. Some months later, the expert appointed by the claimant found numerous items of clothing not identified by insurer's expert. In addition, when the insurer sought the documentary records to show the purchase of those expensive clothing lost in the fire, the claimant produced some bank statements on which he highlighted as being in relation to clothing but it was found later that the money was actually spent for different purposes. The insurer refused to pay on the grounds that the claimant had planted some traces of those expensive clothing in order to support a false insurance claim. The trial judge accepted the insurer's argument and found that the claimant was carelessly dishonest and he planted the traces directly or indirectly in order to support a fraudulent claim. The insured appealed, the appeal was supported and the claim was remitted to rehearing, on the grounds that (1) the trial judge failed to consider the evidence which was given by an important witness; and (2) when the trial judge accepted the suggestion that the insured planted the traces of clothing directly or indirectly, he failed to offer an explanation as to how that planting could have been done.

At the first instance, it seems that the court was attempting to protect the insurer by not giving the benefit of doubt to the insured. However the Court of Appeal insisted that the standard of proof should not be loosened when fraud is alleged.

[2.35] The third case is *Joseph Fielding Properties (Blackpool) Ltd v Aviva Insurance Ltd.*[103] The facts of this case are relatively clear: the units of the insured company's industrial estate were seriously damages by an accidental fire, and the insured submitted a claim for the indemnity from the defendant insurer. The insurer denied the liability on the ground, *inter alia*, that the insured had submitted a false invoice in support of the claim. There was a fraudulent claim clause in the policy stating that the insurer was entitled to avoid the policy *ab initio* if the claim was supported by fraudulent devices. In the light of the evidence, the court was satisfied that the invoice submitted by insured was bogus, with the result that pursuant to the

[103] [2010] EWHC 2192. See the further discussion of this case at Chapter Four, at [4.24]

clause in policy the insurer was not only allowed to deny the liability for the current fire claim but also entitled to recover the money that was paid for the previous genuine claims.

This case demonstrated the advantage for the insurer in having a clear wording fraudulent claim clause in the policy, which will be discussed in detail in Chapter Four.

[2.36] The fourth case is *Sharon's Bakery (Europe) Ltd v (1) AXA Insurance UK Plc (2) Aviva Insurance Ltd.*[104] The facts may be stated in the abstract in the following form. A and B, who ran their respective business through corporate vehicles, decided to merge their business operations and formed a new company C for this purpose. A and B became the directors of the new company. When obtaining secured finance for the new company from Lombard Finance, the documents disclosed by A included an invoice relating to the acquisition of equipment by his original company from a third party company. This transaction had never taken place and it was common ground that the invoice was false. When negotiating the new finance C took out insurance covering, *inter alia*, fire risks. In June 2008, an accidental fire broke out at the company's premises, which caused damage to the company's equipment, and in respect of which the insured submitted a claim for indemnity. In the course of making the claim, the loss adjuster acting for the insurers requested various items of information from the insured, at the same time indicating that it was important for the insurers to fully understand the method by which the new company was established. In this regard the insurers were actually seeking documentary evidence of the transfer of title to the equipment rather than a valuation. In response to the request and in support of the insurance claim, the insured C presented a sham invoice in similar terms to the invoice that A had previously presented in connection with the application for new finance. Upon discovering the true nature of this invoice, the insurers avoided the insurance and rejected the claim.

---

[104] [2011] EWHC 210 (Comm). The case is also concerned with the concept of "moral hazard" in the context of the placement of a risk. For full analysis of the case, see Zheng, R, *Moral Hazard and The Use of Fraudulent Means and Devices in Making a Legitimate Insurance Claim* [2011] JIML 260

In the present case, there was no evidence that the fire was started deliberately. There was also no evidence that the insured was inflating the amount of the loss. The allegation made by the insurers was that the claim for legitimate loss had been supported by the use of fraudulent means or devices. The insurers argued that by submitting the false invoice to satisfy the documentary requirements of the insurers, the insured was making use of a lie in order to improve or embellish its claim. The fact that the claim had a chance of success even without the lie did not change the position, as the lie was intended to yield a significant improvement in the insured's prospects of obtaining a settlement.

Blair J delivered judgements in favour of the insurers: the second false invoice was presented by the insured to the insurers as evidence of a true sale and purchase and in support of the claim on the insurance. The directors of the insured knew that there had been no such transaction but nevertheless chose to lie by providing the invoice. Accordingly, fraudulent means or devices had been adopted in support of the claim and, consequently, all benefit under the policy was forfeited.

[2.37] The fifth case is *Aviva Insurance Limited v Roger George Brown.*[105] The defendant Mr Brown bought a property and insured it with the claimant insurer against, *inter alia*, the losses and damages caused by subsidence including rebuilding or repair cost and also the cost of alternative accommodation if the property became uninhabitable. Mr Brown made two claims for subsidence in 1989 and 1996, the liability was admitted but the dispute arose as to the cost of alternative accommodation. The claim payment process was considerably delayed by the insurer because it was unable to locate alternative accommodation at a price he was willing to pay. The circumstance made Mr Brown think whether he might use his mother's old house (house No.38), which was owned by him, as an alternative accommodation. Mr Brown sent a letter to insurer containing an estate agent's estimation of the rent payable for this property but did not disclose his ownership to insurer. In any event, insurer still thought the price was too high and Mrs. Brown also refused to move into the house. The matter was not taken any further. At a later stage, Mr Brown raised

---

[105] [2011] EWHC 362 (QB). A helpful detailed discussion on this case could be found in Shine, P, *Dishonesty in civil commercial claims: a state of mind or a course of conduct* [2012] JBL 29

another rental suggestion regarding the property next to his current one (house No.15), which belonged to a company of which Mr. and Mrs. Brown were the directors and majority shareholders. The tenancy agreement was entered into between Mr Brown and the company and insurer paid the rent for Mr Brown too. Subsequently, it was found by the insurer the Mr Brown was the owner of house No.38 and also the controller of the owner of house No.15, so the insurer brought the proceedings against Mr Brown on the basis that the claim was made fraudulently and sought to recover the rent that had already been paid to Mr Brown.

The court discussed how fraud shall be demonstrated in length details. First of all, Eder J admitted the mere non-disclosure or silence could not constitute the fraud unless dishonest could be proved. Secondly, Eder J was of the opinion that for the purpose of proving fraud, the insurer must show that the insured's representations or conducts are objectively dishonest, and he must also prove that the insured himself is aware that he is acting dishonestly.[106]

As to the allegation regarding house No.38, the essence of the plead was that Mr Brown, being the owner of house No.38, falsely represented that it was available to rent and recruited the estate agent to provide the relevant false letter to the insurer in support of his claim. The court held that, objectively, the letter was false and subjectively, Mr Brown himself must realize what he was saying in the letter was dishonest. The argument that Mr Brown genuinely believed that No.38 was owned by the third party trust was rejected on the basis that there was no documents at all that can record and explain the transfer of the property to the trust and also the argument was inconsistent with some statements made by Mr Brown. Therefore, a fraudulent claim by using of fraudulent devices or means was established.

As to the allegation regarding house No.15, the court held that objectively, the representation that No.15 was available for rent from the company was true because the company was a complete separate legal entity. The conclusion of the court would not be affected by the fact that Mr Brown was the controller of the company and may get financial benefit by any rental of the house through his interest as a majority shareholder. In addition, subjectively, the court accepted that Mr. Brown was in the

[106] See the discussion on this dual elements test in Chapter One, at [1.3]

opinion that the company was a separate legal entity and therefore he was entitled to rent the property from it. Accordingly, a fraudulent claim in respect of house.No15 could not be established. The insurer failed in this regard.

The significant value of this case is that it has demonstrated the way of proving fraud in front of the court, namely, objective and subjective elements being both required to be proved on the balance of probabilities in order to establish the fraud. However, the consequence of the judgement is seemingly going too far to the disadvantages on the part of the insured. First of all, the judge admitted that the classical definition of fraud identify in *Derry v Peek* and *Agapitos v Agnew* were difficult to apply in this case because the alleged fraudulent claim or use of fraudulent means related in part at least to a time before there was any actual loss in relation to alternative accommodation. This proceeding was pushed forward on the basis that barristers representing the case were in the agreement that similar principles could apply.[107] This consent to some extent actually wavered the judicial foundation of the acute judgement; Secondly, in *Agapitos v Agnew*, it is clearly stated that materiality is required in the context of use of a fraudulent device or means, namely an obviously irrelevant lie that could not sensibly have had any significant impact on any insurer or judge should not be taken into account. In the present case, on the one hand, the lie committed by the insured regarding house No.38 was never substantialized because neither he had moved in that house nor was any sum paid by the insurer in this respect; on the other hand, the sum paid by the insurer was based on an agreement in which no fraud was involved. Accordingly, it seems that the judge may apply the test in an incorrect way into the facts of the case. Thirdly, the considerable delay in payment on the part of the insurer cannot be justified because Financial Services Ombudsman Service had concluded that insurer should provide Mr Brown with alternative accommodation for the full repair period and to the same standard as the insured property, whereas the insurer continued to attempt to resile from that position by suggesting that a smaller house would be reasonable. The insurer's unreasonable act was not considered by the court at all, which may be inappropriate under these surrounding circumstances. It was suggested by the Court of Appeal in the case of

[107][2011] EWHC 362 (QB), [63]

Drake Insurance Plc v Provident Insurance[108] that the insurer who is in breach of his duty of good faith may not be allowed to avoid the contract. Similarly, it is suggested that certain measures shall be raised to protect the legal interest of the insured and punish the egregious insurer accordingly.

[2.38] The most recent case is *The Buana Dua.*[109] The claimant insured its tug *Buana Dua* with three underwrites: the leading underwriter Axa HK, the defendant insurer and Aegis. There was a leading underwriter clause in the policy stating that: "it is agreed to follow Axa HK in respect of all decisions, surveys and settlements regarding claims within the terms of the policy, unless these settlements are to be made on an *ex gratia* or without prejudice basis". The vessel ran aground and was subsequently declared to be a constructive total loss. Notice of abandonment was served but was rejected. Nevertheless, the leading underwriter Axa HK decided to settle the claim with the claimant and paid his share. However, the defendant refused to pay his share on the basis that the defendant had breached a warranty prohibiting the vessel from undertaking towage or salvage services and he was not bound by the leading underwriter's settlement, and in any event, the defendant was not liable for the claim because on two previous occasions fraudulent misrepresentations were made on behalf of the claimant to the defendant that the insured was never intended that the vessel should undertake the towage of another vessel .

As to the issue of fraudulent misrepresentations, the insured contended that they were made after the leading underwriter had settled the claim and the defendant insurer was bound to follow the settlement. This was a time when the insured and insurer were no longer in a relationship which attracted the duty of good faith in the presentation of the claim, so the fraudulent misrepresentations could not give rise to any real prospect of success where the defendant was already obliged to follow the leading underwriter's settlement decision. Furthermore, the insured argued that the leading underwriter wrote a letter to him before the settlement agreeing to put him in the same position as if a writ had been issued, so there was no longer any duty of

[108][2004] 1 Lloyd's Rep.268 (CA)

[109] *PT Buana Samudra Pratama v Marine Mutual Insurance Association (NZ) Ltd (The Buana Dua)* [2011] EWHC 2413 (Comm)

good faith in presentation of claim as it has been firmly established in the case of *The Star Sea* that when a writ is issued and once the parties are in litigation it is the procedural rules which govern the relationship between the parties not just duty of good faith as such.[110] In response, the insurer argued that the duty not to use fraudulent means or devices derived from the common law and was independent of the duty of good faith and, therefore, did not come to an end once the leading underwriter decided to settle the claim. In any event, the letter agreeing to put the insured in the same position as if a writ had been issued would not lead to the cease of duty of good faith because the purpose of the letter was to counter the doctrine of ademption and was no justification for concluding that the duty not to use fraudulent devices or means had ceased. [111]

---

[110] *Ibid.*, [47]. See Chapter Four, at [4.92]

[111] *Ibid.*, [48]-[49]. According to Sections 61 and 62 of the Marine Insurance Act 1906, where there is a constructive of total loss, if the insured would like to treat the loss as if it were an actual total loss, he must abandon the subject-matter of insured to the insurer by giving notice of abandonment to the insurer. If the insurer declines to accept the notice, the insured must resort to legal proceedings to enforce a claim for total loss. According to the doctrine of ademption in English law, the insured could not claim for total loss if, by the time of the beginning of legal proceedings, there once was a total loss but this has ceased to be the case (the basic meaning of the doctrine of ademption is that a person cannot bequeath what he does not own, and in the case of *Hamilton* v *Mendes* (1761) 2 Burr 1198, Lord Mansfield justified the application of this doctrine in marine insurance case on the basis that marine insurance contract is a contract of indemnity). In practice, where the insurer decides to reject the notice of abandonment, he nevertheless, in order to counter the effect of doctrine of ademption, upon the request of the insured, would agree the put the insured in the same position as if the writ had been issued by agreeing that the date of notice of abandonment will be deemed to be the date of issuing of writ. The validity of the notice of abandonment will, therefore, be determined with reference to the time when it was made not when the writ is actually issued. For the purpose of the current arguments, the author of this thesis agrees that the duty not to use fraudulent means or devices will only apply before the commencement of court or arbitration proceedings, see Chapter Four, at [4.13], but does not agree that in the present case what the insurer agreed could be deemed to be the commencement of proceedings for the purpose of ceasing the duty of good faith or common law duty in presentation of claim. Lord Hobhouse in *The Star Sea* [2001] 1 Lloyd's Rep.389, [73]-[78] clearly explained the policy considerations to restrict the duty of good faith to the pre-litigation period. His Lordship explained the difference of parties' relationship between the pre-litigation stage and the litigation

The court gave the summary judgement in respect of the issue of the leading underwriter clause, holding that on the true construction of the clause in question the defendant was obliged to follow the decision whether or not there had been a breach of warranty. However, the court refused to order the summary judgement as to the issue of fraudulent representations. The court was of the opinion that the defendant had an arguable case that claimant made two fraudulent misrepresentations and he had real prospects of succeeding on his defence that the claimant had committed the fraudulent claim by using the fraudulent device. The court admitted that this is an area of law which is in a process of elucidation and development, thus it was inappropriate to determine the merits of the opposing arguments on the basis of assumed facts: the precise facts should first be found before the insured's "novel and interesting argument" can be determined. In other words, the defence based upon the alleged fraudulent misrepresentation must be determined at trial.[112]

[2.39] A few conclusions may be extracted from the above cases: First of all, the use of fraudulent devices and means may have already become one of the most popular defences which the insurers are willing to adopt; Secondly, the burden of proof and the standard of proof are still very strict in the opinion of the court. The learned

---

stage: "before the litigation starts the parties' relationship is purely contractual subject to the application of the general law...when the litigation starts, Their relationship and rights are now governed by the rules of procedure and the orders which the Court makes on the application of one or other party. The battle lines have been drawn and new remedies are available to the parties", and it is clear what the insurer agreed in the present case could not bring the parties' relationship into the litigation stage as described by Lord Hobhouse. The agreement is for the sole purpose of defeating the effect of the doctrine of ademption and nothing more; it could not bring the contractual relationship between the parties to an end. In this regard, the author is in agreement with the submission by the leading textbook Eggers, PM & Picken, S& Foss, P, *Good Faith and Insurance Contracts*, 3rd edn, Lloyd' list (2010), 11.102: "it would be illogical for the duty of good faith as regards claims to come to an end at the time when such a clause is agreed, because it is upon the tender of the notice of abandonment that the assured in effect presents his claim. For the insurer to decline the claim by rejecting the notice of abandonment and agreeing to such a clause would mean that the insurers would continue their inquiries without the benefit of a duty which would continue to apply in respect of all other insurance claims."

[112] *Ibid.*, [50]

judges may not be apt to give the benefit of doubt to the insurers when the relevant facts are not ascertained, nor their Lordships will be willing to give the summary judgement in the cases involving alleged fraud when the facts are not ascertained; Thirdly, however, if the burden of proof is discharged, the court is seemingly very hostile to the fraudulent act of the insured and will not hesitate to invoke the appropriate remedy to punish the fraud. Courts can hardly be criticized for taking a hard line on fraud because this issue obviously has public policy dimensions but sometimes courts may go too far as they are supposed to be. Nevertheless, this area of law is still in the state of constant development, and some uncertainties still exist which are expected to be gradually solved by the subsequent cases.

IV. Fraudulently Suppressing the Defence

[2.40] It might be the case that the insured indeed has a genuine loss and seek to claim an indemnity from the insurer. But in order to promote his claim, he deliberately misrepresents the facts and suppresses a defence which he knows to be open to underwriters, e.g. an exclusion or breach of warranty or condition precedent. This kind of fraud has been defined in *The Captain Panagos DP*[113] as the one "which is made on the basis that facts exist which constitute a loss by an insured peril, when to the knowledge of the assured those alleged facts are untrue".

[2.41] In the case of *The Michael* again,[114] the insureds claimed for the total loss of their vessel which sunk. The claim was originally presented on the basis that the loss had been caused by perils of the sea, but by the time of the trial, it was common ground that there was a loss by barratry. Insurers defended the claim on the ground, *inter alia*, that the fraudulent claim was committed because the insureds were presenting or persisting in the claim as a loss by perils of the sea when they knew that a loss by barratry had occurred. However, this argument failed both at the first

[113] [1986] 2 Lloyd's Rep.470, 511

[114] [1979] 1 Lloyd's Rep.55 (the High Court); [1979] 2 Lloyd's Rep.1(the Court of Appeal)

instance and in the appeal. The court found that the owners' initial claim for loss by perils of the seas had not been put forward fraudulently in the sense that the owners had no knowledge that one of the officers on board would scuttle the vessel.[115] As to the allegation of subsequently maintaining a fraudulent claim, the court held that the insureds were not to be found guilty of fraud merely because, with the wisdom of hindsight, they had information which might, if appreciated at its true value, have led them to the truth at an earlier date. The insureds in litigation were not maintaining fraudulent claims merely because during the interlocutory proceedings their solicitors became aware of evidence which may militate against the correctness of the case and its likelihood of ultimate success. The relevant test must be honest belief.[116] Nevertheless, it can be seen clearly from the analysis of the Court that there was an apparent assumption that misrepresenting the premise of the case could amount to a fraudulent claim.

[2.42] Fraudulently suppressing the defence may be regarded as one of the situations where the insured dishonestly mislead the insurers or their surveyors or legal advisers. In *Bucks Printing Press v Prudential Assurance*,[117] the goods were insured under the standard Institute Cargo Clauses, which contained the clause that excluded the damages caused by insufficient packing. The insured gave the insurer's solicitor information, saying that the goods were properly packed and secured in the container, whereas in fact his description of the packing was materially inaccurate. The court held that the representations in respect of the packing were made recklessly; the insured completely showed an indifference to the truth, so the claim failed on the basis that it was advanced fraudulently.

[2.43] Suppression sometimes means the act of preventing or withholding important information from becoming known especially from people who have a right to

---

[115] [1979] 1 Lloyd's Rep.55, 89

[116] [1979] 2 Lloyd's Rep.1, 22

[117] Unreported: Commercial Court, 26 February 1991, Saville J. See Dunt, J, *Marine Cargo Insurance*, Informa (2009), 13.10

know,[118] and this meaning sometimes indicates the act of non-disclosure. However, it is clear that there is no general duty of disclosure in post-contractual stage. A failure to disclose in the claims process becomes a fraudulent claim only where there is the deliberate suppression of a known defence. This position was considered indirectly in *Marc Rich Agriculture Trading SA v Fortis Corporate Insurance NV*.[119] The case concerned the loss of a cargo of wheat which had been insured by the insurers on a warehouse to warehouse basis. The insurers were informed of the loss on 29 June 2000 by means of a fax from the insured's brokers, which stated that further information was to follow. There were subsequent exchanges between the parties including a notification from the insured that he intended to conclude an agreement with "N"-a third party responsible for removing the cargo under which he would pay for the cargo. Such an agreement was entered into on 12 September 2000. The insurers refused to pay on the ground, *inter alia*, that there had been a fraudulent claim, in the sense that the insured had deliberately concealed from the insurers the fact that the loss had been discovered on 16 May but there had been no notification at that stage, and on discovering the loss the insured initially attempted to prevent further removals of cargo by the "N" but had subsequently abandoned that attempt on the basis that it could prejudice negotiations for future payment by "N". In this case, the insurers only relied upon the failure of disclosure rather than any lie presented by the insured, and the insured sought to strike out this defence.

Cooke J found in the first place that there was no room for a duty of good faith operating in the context of presentation of a claim to require a duty of disclosure as opposed to a duty not to make misrepresentations. His Lordship, however, acknowledged that the deliberate suppression by the insured of a known defence is a class of fraudulent claim, but which was not available in this case because there was no known defence: the most that had occurred was that the insured had withheld certain facts. He neatly summarized the legal positions as follows:[120]

> "A deliberate fraudulent non-disclosure would suffice, and, for this purpose, it would be right to look at the whole process by which the claim was put to the insurers and all the

---

[118] *Longman Dictionary of Contemporary English*, Pearson Education Limited(2001)

[119] [2005] Lloyd's Rep.IR.396

[120] *Ibid.*, [31]

information supplied up to the beginning of litigation. Honesty, he [Richard Lord QC] said, was the key, that being made plain by the decision of the House of Lords in *The Star Sea* [2003] 1 A.C.493. He [Richard Lord QC] said that the emphasis in that case was on the difference between honesty and dishonesty, and that there was no particular distinction being drawn between fraud in the sense of misrepresentation and deliberate non-disclosure on the other. Dishonesty was the key in the presentation of the claim whether that was a dishonesty which was brought about by telling the clear lie or brought about by not stating and specifically deliberately suppressing certain matters which the insured did not want the insurer to know."

V. Fraudulently Maintaining an Initially Honest Claim

[2.44] It has been concluded in Chapter One that a representation may be held as being false and therefore capable of incurring the liability of fraud, if the representor fails to correct the representation which is true when it is made but subsequently becomes false or being discovered by the representor to be false.[121] Similarly, a claim which is initially honest may become fraudulent if the insured subsequently finds that no loss has happened or the claim is exaggerated but continues to maintain it. It is suggested that "as a matter of principle, it would be strange if an insured who thought at the time of his initial claim that he had lost property in a theft, but then discovered it in a drawer, could happily maintain both the genuine and the now knowingly false part of his claim, without the risk of application of the rule."[122]

[2.45] However, it is suggested[123] that if the insured has lost property which is restored to or found by him prior to payment by the insurers, the above proposition may not be absolutely correct. As a matter of practice, insurers usually pay for a total loss following serious damage which renders repair uneconomic, assuming that something remains of the subject-matter, the insurer is entitled to claim for his own benefit the right of ownership of that subject-matter by way of salvage at least where

[121] See Chapter One, at [1.16]

[122] *Agapitos v Agnew* [2002] 2 Lloyd's Rep.42, [15]

[123] Merkin, R, *Colinvaus's Law of Insurance*, 8th edn, Sweet&Maxwell (2006), 9-23, 11-59

the insured will receive a full indemnity. In *Moore v Evans*,[124] it was clearly stated that the insurers would have been entitled to claim the jewellery on its return to the insured had they paid for a total loss. Accordingly, the insured can possibly argue alternatively that the true position of this type of case is that due to the insured's non-disclosure that property has been recovered, the insurer's right of salvage is deprived. The insurer can claim the property instead and therefore no fraudulent claim rule will be invoked.

VI. Miscellaneous: Fraud in Composite and Joint Policies

[2.46] It is a common practice to have many insureds on the same policy nowadays, so the distinction must be drawn between insureds who have a true joint interest in the property insured and those who are insuring separate interests under different contracts of insurance which may be embodied in a single policy. In *Direct Line v Khan*,[125] Direct Line paid out £69,000 under a Building & Contents policy to the defendant husband and wife following a fire at their house. Approximately £8,000 of the claim was a fraudulent attempt to gain payment for rent on alternative accommodation, which in fact the first defendant Mr Khan owned. Direct Line argued that because of this fraud the whole claim was forfeited. Mr and Mrs Khan were noted as joint policyholders. Mrs Khan argued *inter alia* that since the fraud was perpetrated solely by her husband and she did not know about it, her contractual relationship with Direct Line was not affected. The Court of Appeal held that Mr. Khan's actions were carried out on his behalf and as agent for his wife. Therefore, Mrs Khan was bound by such actions, being unable to show that Mr. Khan had acted outside that agency. Consequently neither Mr nor Mrs Khan was entitled to any part of the claim. Another example is where a mortgagee who may not himself be guilty of any act of wilful misconduct sought to recover as assignee to a policy of insurance, his claim may nevertheless be rejected due to the wilful misconduct of the assignor, as he has

[124] [1917] 1 KB 458

[125] [2001] Lloyd's Rep.IR.364

no original or independent interest in the policy.[126] In contrast, where the policy in question was a Mortgagee's Interest Policy, which represented an independent contract between the mortgagee and the mortgagee's interest insurer, the insured property was wilfully set on fire with the connivance of the insured and yet an innocent mortgagee successfully recovered on his policy of insurance.[127]

[2.47] Whether the policy in question is joint or composite is basically an issue of interpretation. For example, in *Arab Bank plc v Zurich Insurance Co*[128], after construing the policy as a whole, the Court recognized that a fraudulent claim clause in this professional indemnity policy which insured the company and its directors compositely should be regarded as applying to each of the insured separately and any insured who was personally innocent of an intent to deceive should be entitled to resist punishment. The policy in question expressly contemplated that individual insured may be covered where others may not be because several clauses, e.g. the innocent non-disclosure clause and subrogation clause in the policy was designed to ensure that it was only the individual insured guilty of dishonest conduct which was prejudiced by his dishonesty, but not other innocent insured.

---

[126] *Graham Joint Stock Shipping Co Ltd v Merchants' Marine Insurance Co* (1923) 17 LIL Rep.44

[127] *The Alexion Hope* [1987] 1 Lloyd's Rep. 60; [1988] 1 Lloyd's Rep 311 (CA)

[128] [1999] 1 Lloyd's Rep.262

CHAPTER THREE

BURDEN OF PROOF IN CIVIL FRAUD ALLEGATIONS

One deceit needs many others, and so the whole house is built in the air and must soon come to the ground.

——Baltasar Gracian

[3.1] In *Herbert Morris Ltd v Saxelby,*[1] Lord Parker stated the basic principle relating to burden of proof in civil law in a very terse fashion: "the onus of proving such special circumstances must, of course, rest on the party alleging them." Applying it in the context of insurance fraudulent claims, the general position is fraud must be clearly and unambiguously established by the insurer, but in certain circumstances in order to avoid the liability under the insurance contract, the insurer may take advantage of burden of proof and may not need to prove fraud in the first place.[2]

I. Strong Evidence Required

[3.2] By the policy of the law, where, in a civil case, a charge of fraud is made, that is an allegation that must be particularized with exactitude and proved as pleaded.[3] In the context of insurance cases, it is submitted by Mance LJ that underwriters "could only plead fraud if they had clear evidence of fraud."[4] The importance of pleading and

[1] [1916] 1 AC 688, 707

[2] See the illustration below, at [3.8]

[3] *Dome Mining Corp Ltd v Drysdale* (1931) 41 LIL.Rep.109, 119

[4] *Agapitos v Agnew* [2002] 2 Lloyd's Rep.42, [55]

particularizing an allegation of fraud was explained by Lord Millett in *Three Rivers District Council v Governor and Company of the Bank of England (No.3)*:[5]

> "An allegation of fraud or dishonesty must be sufficiently particularized, and that particulars of facts which are consistent with honesty are not sufficient. This is only partly a matter of pleading. It is also a matter of substance. As I have said, the defendant is entitled to know the case he has to meet. But since dishonesty is usually a matter of inference from primary facts, this involves knowing not only that he is alleged to have acted dishonestly, but also the primary facts which will be relied upon at trial to justify the inference. At trial the court will not normally allow proof of primary facts which have not been pleaded, and will not do so in a case of fraud. It is not open to court to infer dishonesty from facts which have not been pleaded, or from facts which have been pleaded but are consistent with honesty. There must be some fact which tilts the balance and justifies an inference of dishonesty and this fact must be both pleaded and proved."

[3.3] Similarly, from the perspective of a barrister who is requested to plead fraud on the part of insured, the Bar Council Code of Conduct Part VII Section 704 states that:

> "A barrister...must not draft any statement of case, witness statement, addidavit, notice of appeal or other document containing...any allegation of fraud unless he has clear instructions to make such allegations and has before him reasonably credible material which as it stands established a prima facie case of fraud."

Under Section 708 it goes on to state that a barrister:

> "...when conducting proceedings in court...must not suggest that a victim, witness or other person is guilty of crime, fraud or misconduct or make any defamatory aspersion on the conduct of any other person or attribute to another person the crime or conduct of which his lay client is accursed unless such allegations go to a matter in issue...which material to the lay client's case and appear to him to be supported by reasonable grounds."

Therefore, it is a professional rule of conduct for barristers that they must not allege fraud nor even raise the argument in the manner in which they run a trial unless

[5] [2003] 2 AC 1, [183]-[186]

they have in their hands some evidence for the fraud alleged. Barristers are notoriously reluctant to plead fraud.

[3.4] It is possible that only when the case has progressed through pleadings, disclosure of documents, exchange of witness statements and expert's report and after some of the insured's key witnesses have given the evidence at trial, the insurers might then seek the permission of the court to plead fraud once they and their barristers are satisfied they have sufficient evidence to establish a *prima facie* case against fraud. Thus, the difficulty in proving fraud has led to a situation where underwriters do not advance any positive defence but simply play the game of burden of proof and put the onus on the insured to prove the loss.[6]

II. Standard of Proof and Burden of Proof

[3.5] The allocation of burden of proof is a question of law, and it is firmly established that the burden rests unequivocally on the insurers to prove the fraudulent conduct committed by the insured, but the standard of proof might be different from the usual civil cases, as Lord Denning suggested that:[7]

> "A Civil Court, when considering a charge of fraud will naturally require for itself a higher degree of probability than that which it would require when asking if negligence is established. It does not adopt so high a degree as a Criminal Court, even when considering a charge of a criminal nature; but still it does require a degree of probability which is commensurate with the occasion."

This means that although the same "balance of probabilities" test applies, depending upon the nature and the seriousness of the allegation, a higher degree of

[6] It was described by Professor Baris Soyer that depending upon the person on whom the burden of proof lies, the defence available to the insurers could be classified as two categories: the negative defence and the positive defence. See Soyer, B, *Defence Available to a Marine Insurer* [2002] LMCLQ 199. See the application of this rule below, at [3.7] and [3.8].

[7] *Hornal v Neuberger Products* Ltd [1957] 1 QB 247, 263

proof is in fact required in these cases, something approaching the criminal standard, in order to commensurate the gravity of the accusation.[8] Lord Nicholls nicely and explicitly summarized the points which deserve a full citation as follows:[9]

> "The balance of probability standard means that a court is satisfied an event occurred if the court considers that, on the evidence, the occurrence of the event was more likely than not. When assessing the probabilities the court will have in mind as a factor, to whatever extent is appropriate in the particular case, that the more serious the allegation the less likely it is that the event occurred and, hence, the stronger should be the evidence before the court concludes that the allegation is established on the balance of probability. Fraud is usually less likely than negligence. Deliberate physical injury is usually less likely than accidental physical injury. A step-father is usually less likely to have repeatedly raped and had non-consensual oral sex with his underage stepdaughter than on some occasion to have lost his temper and slapped her. Built into the preponderance of probability standard is a generous degree of flexibility in respect of the seriousness of the allegation.
>
> Although the result is much the same, this does not mean that where a serious allegation is in issue the standard of proof required is higher. It means only that the inherent probability or improbability of an event is itself a matter to be taken into account when weighing the probabilities and deciding whether, on balance, the event occurred. The more improbable the event, the stronger must be the evidence that it did occur before, on the balance of probability, its occurrence will be established. Ungoed-Thomas J. expressed this neatly in In re Dellow's Will Trusts [1964] 1 W.L.R. 451, 455: "The more serious the allegation the more cogent is the evidence required to overcome the unlikelihood of what is alleged and thus to prove it."
>
> This substantially accords with the approach adopted in authorities such as the well known judgment of Morris L.J. in Hornal v. Neuberger Products Ltd. [1957] 1 Q.B. 247 ,

[8] *The Ikarian Reefer* [1995] 1 Lloyd's Rep.455, 459 (Stuart-Smith LJ)

[9] *Re H* [1996] AC 563, 586-587. The proposition made by Lord Nicholls was criticized because the foundation of this proposition, namely serious events are less likely than non-serious ones, seems debatable at best, as Lord Lloyd alleged at 577 that "it would be a bizarre result if the more serious the anticipated injury, whether physical or sexual, the more difficult it became for the local authority to satisfy the initial burden of proof". The worries could be justified in child caring cases, but in the insurance fraud context, the reasoning given by Lord Nicholls seems no big theoretical shortfall at all. See Dennis, I, *The Law of Evidence*, 3rd edn, Sweet&Maxwell, 11.48

266. This approach also provides a means by which the balance of probability standard can accommodate one's instinctive feeling that even in civil proceedings a court should be more sure before finding serious allegations proved than when deciding less serious or trivial matters."

[3.7] Issues may emerge when the court is presented with alternative theories regarding the cause of loss. For instance, in the case of *Yeganeh v Zurich Insurance Co*,[10] at the first instance, one of the defences raised by the defendant insurer was that the claim was fraudulent because the fire causing the loss was set on deliberately by the claimant insured. The Counsel for the insurer submitted that there were only two possible causes of the fire: an accident resulting from the positioning of the halogen heater or deliberate acts by the Claimant. The accident theory is improbable and wholly implausible because the accident could only occur if the heater was in a unique position. Therefore, the only possibility left was that the fire was deliberately ignited by the claimant insurer.

Reference for considering this kind of allegation could be resort to the case of *The Popi M.*[11] The plaintiff shipowners sought to recover under a policy of marine insurance for the total loss of the ship by perils of the sea. The ship, an elderly and poorly-maintained one with wasted shell-plating, sank in calm seas in the Mediterranean as a result of a sudden and unexplained inrush of the water into her engine-room, the plaintiffs contended that the proximate cause of the loss was collision with a submerged submarine but were unable to produce any evidence of this. The defendants contended that it was caused by wear and tear upon the hull, causing it to open up under the ordinary action of wind and waves. There was no direct evidence in support of the defendant's contention and the trial judge could not find in favour of it. In this state of the evidence, the House of Lords held that the plaintiffs' claim failed, since the legal burden of proving a loss by perils of seas was on them and they had failed to discharge from it. It was immaterial that the defendants had failed to prove their alternative explanation for the casualty. Lord Brandon rejected the argument what he called as "dictum of Sherlock Holmes" that "when you

[10] [2010] EWHC 1185 (QB) (High Court) [2011] EWCA Civ.398 (Court of Appeal);

[11] *Rhesa Shipping Co.S.A v Herbert David Edmunds & Fenton Insurance Co.Ltd (The Popi M)* [1985] 2 Lloyd's Rep.1(House of Lords)

have eliminated the impossible, what remains, however improbable, must be the truth". First of all, his Lordship said that the Holmes approach "can only apply when all relevant facts are known, so that all possible explanations, except a single extremely improbable one, can properly be eliminated."[12] In this case, the situation was clearly otherwise. In addition, his Lordship considered that the Holmes approach was not appropriate because the legal concept of proof "requires a Judge of first instance, before he finds that a particular event occurred, to be satisfied on the evidence that it is more likely to have occurred than not. If such a Judge concludes, on a whole series of cogent grounds, that the occurrence of an event is extremely improbable, a finding by him that it is nevertheless more likely to have occurred than not does not accord with common sense".[13] His Lordship suggested the correct approach on burden of proof as follows:[14]

> "Judge is not bound always to make a finding one way or the other with regard to the facts averred by the parties. He has open to him the third alternative of saying that the party on whom the burden of proof lies in relation to any averment made by him has failed to discharge that burden. No Judge likes to decide cases on burden of proof if he can legitimately avoid having to do so. There are cases, however, in which, owing to the unsatisfactory state of the evidence or otherwise, deciding on the burden of proof is the only just course for him to take."

Therefore, in *Yeganeh v Zurich Insurance Co*, after carefully considering all the evidence, the learned judge held that in the absence of having shown any discernible motive for the insured to set the fire on the property, the insurers had not brought enough evidence to discharge their burden regarding the allegation that the cause of loss being the arson.[15]

---

[12] *Ibid.*, 6

[13] *Ibid.*

[14] *Ibid.*

[15] Although the finding of fraud by trial judge in the present case was reversed by the Court of Appeal, the finding on this respect has not been challenged on the appeal. See Chapter Two, at [2.34]

[3.8] It is noteworthy that *Yeganeh v Zurich Insurance Co* is a case of fire-damage claim. As an insurable risk, the element of fortuity is not a prerequisite to a claim for a loss by fire.[16] Thus, the insured need only show that the loss is caused by fire, whether started accidentally or deliberately, to establish a *prima facie* case and then throw the burden of proof upon the insurer to prove that it is the insured that set the subject matter insured on fire or the arson is committed with the connivance of the insured. If the evidence leaves the court in doubt, then the insured is entitled to succeed.[17] Accordingly, the insured in a claim for loss by fire has a lesser burden than one claiming for loss by an insurable risk that needs an element of fortuity, e.g. perils of the sea in marine policy.

Nevertheless, the general position is insurers do not need to prove fraud until the insured has established the claim is within the policy. If the policy is an "all risk" cover, the insured is not required to show how the loss occurred; he only needs to prove that the loss in fact occurred, and that it was a casualty, not a certainty.[18] The onus is then placed upon the insurer to prove otherwise. If the policy is "named risk" cover, the insured has to show on the balance of probabilities that an insured risk was the proximate cause of the loss, and then the burden of proof switches to insurers to prove fraud. If the insured cannot discharge his burden, the insurer's allegation of fraud may never need to be raised. The insurer's position in this regard may even be reinforced by asserting a "Reverse Burden of Proof" clause into the insurance contract so the insured has to justify every aspects of his claim on the balance of probabilities.[19]

---

[16] *The Alexion Hope* [1988] 1 Lloyd's Rep.311 (Court of Appeal)

[17] *Slattery v Mance* [1962] 1 ALL ER 525; *The Ikarian Reefer* [1995] 1 Lloyd's Rep.455

[18] *Scholoss Bros v Stevens* [1906] 2 KB 665; *British and Foreign Marine Insurance Co v Gaunt* [1921] 2 AC 41

[19] The clause may read: "if the Insurer acting reasonably alleges in writing that any claim is excluded from coverage by this exclusion, the burden of proving the contrary shall be on the Insured." See Henley, C, *Drafting Insurance Contract,* Leadenhall Press (2010), 3.88.3 and 3.159. The true effect of this clause was explained by Lord Mustill in *Spinneys Ltd v Royal Insurance Co Ltd.* [1980] 1 Lloyd's Rep.406: "the insurers cannot bring the clause into play simply by asserting that the loss was excluded by a particularly exception, and challenging the insured to proved to the contrary. They must produce evidence from which it can reasonably be argued that (a) a state of

The surrounding circumstance of the case may be that the insured provides an unlikely story to support his claim and that there is little evidence either to substantiate the claim or repudiate it. In this situation, rather than alleging fraud, it might be a better approach for insurers to point out that it is for the insured to prove his claim and argue that he has not done so on this occasion. In *Whitehead v Hullett*,[20] the insured's company was defendant in a legal action in the Chancery Division of the High Court in London. The insured alleged that he had taken a diamond necklace with him in the inside pocket of his suit when attending Court. The courtroom was crowded and, when leaving, he said he checked his pocket to find that the necklace was not there. Insurers, rather than alleging fraud, denied that the insured had suffered any loss. The Court stated that the insured must provide reliable evidence to support his claim and agreed that the insured's story was unlikely and his claim failed.

[3.9] More typically, the case of *The Milasan*[21] could demonstrate the above proposition regarding the burden of proof in a clearer fashion and thus be worthy of careful consideration. In this case, a motor yacht *Milasan* sank at 18.10 by the stern in calm water and good weather about 25 miles off Cape Spartivento which was on the eastern Calabrian coast. The vessel was in the course of a voyage from Piraeus via the Corinth canal to Puerto Cervo in Sardinia where her owner (Sheikh Khalid A Abbar) and his family and friends were to join her for a summer cruise. On the voyage from Greece she had on board a master, an engineer and a deckhand. The master said he first saw water rising fast in the engine room bilges at about 17.00 hours and thought it was flowing in on the port side aft and that it quickly rose above the floor plates. The engineer said attempts to stem the flow were unsuccessful. By about 17.30 the crew had taken to a life raft and the vessel sank about 40 minutes later. On July 24 the defendant insurers were advised that the vessel had been lost and that a claim on the vessel's hull insurance would be made. The first claimant (Brownsville) was the legal

affairs existed or an event occurred falling within an exception; and (b) the excepted peril directly or indirectly caused the loss. It is only when an arguable case of this nature is made out that the insured is required to disprove it."

[20] (1945) 79 LIL.Rep.410

[21] [2000] 2 Lloyd's Rep.458

and registered owner of the vessel and the second claimant (Sheikh Khalid) was the beneficial owner and they claimed under the policy of marine insurance dated May 7, 1995 with the defendant insurers for the total loss of the vessel. The insurers rejected the claim and the claimants brought an action against the insurers under the policy. The claimants alleged that the vessel was lost through an accidental incursion of seawater into the engine room and then the aft accommodation. They argued that the proximate cause of the sinking was water gaining access to the aft accommodation. The insurers denied that the vessel sank as a result of an insured peril. They contended that the proximate cause of the loss of the vessel was the initial incursion of seawater into the engine room and they alleged that the claimants could not demonstrate (on a balance of probabilities) that a particular mechanism for the incursion of seawater was caused by an insured peril. The insurers further alleged that the vessel was deliberately cast away by the acts of the master and the engineer with the connivance of her owner Sheikh Khalid.

After carefully considering the evidence as a whole, Aikens J made the following rulings, which could be regarded as a classical clarification and summary in respect of the burden of proof issues in the case of marine insurance, shining lights on the shadows of non-marine insurance in general, too.[22]

(1) It was for the claimants to prove that the loss was caused by an insured peril, on the balance of probabilities. There was no rebuttable presumption of loss by perils of the seas operating where a seaworthy ship was lost in unexplained circumstances.

Where the assured proved that the vessel was seaworthy before the start of the voyage, and was lost in unexplained circumstances, the probability was that she was lost by perils of the seas because she was seaworthy. If the assured did not prove seaworthiness, and if there was some evidence as to the loss (e.g., a rescued crew) the loss could not be regarded as unexplained;

(2) An incursion of seawater into a vessel was not, by itself, a peril of the seas;

(3) The claimants had to identify and prove (on the balance of probabilities) why water entered a vessel in order to identify the cause of entry as a peril of the seas;

[22] See Professor Rob Merkin, *Fraudulent Claims*, paper delivered at the NZILA conference, 2000, available at http://www.nzila.org/index.asp, accessed on 3rd April 2012.

(4) If a defendant insurer was to succeed on an allegation that a vessel was deliberately cast away with the connivance of the owner, then the insurer had to prove both aspects on the balance of probabilities. However, as such allegations amounted to an accusation of fraudulent and criminal conduct on the part of the owner, then the standard of proof that the insurer had to attain to satisfy the court that its allegations were proved had to be commensurate with the seriousness of the charge laid – effectively the standard would not fall far short of the criminal standard;

(5) Although there was no presumption of innocence of the owners, due weight was to be given to the consideration that scuttling a ship would be fraudulent and criminal behaviour by the owners;

(6) When deciding whether the allegation of scuttling with the connivance of the owners was proved, the court had to consider all the relevant facts and take the story as a whole. By the very nature of those cases it was usually not possible for insurers to obtain any direct evidence that a vessel was wilfully cast away by her owners, so that the court was entitled to consider all relevant indirect or circumstantial evidence in reaching a decision;

(7) It was unlikely that all relevant facts would be uncovered in the course of investigations. Therefore it would not be fatal to the insurers' case that "parts of the canvas remain unlighted or blank";

(8) Ultimately the issue for the court was whether the facts proved against the owners were sufficiently unambiguous to conclude that they were complicit in the casting away of the vessel;

(9) In such circumstances the fact that an owner was previously of good reputation and respectable would not save him from an adverse judgment;

(10) The insurers did not have to prove a motive if the facts were sufficiently unambiguously against the owners, but if there was a motive for dishonesty then it might assist in determining whether there had been dishonesty in fact.[23]

---

[23] This is the position in common law, as it has been discussed in Chapter One at [1.32]. See also *The Ikarian Reefer* [1995] 1 Lloyd's Rep.455, 503-504, where it was held that there was clear evidence of financial motive and a good reason to dispose of ship by scuttling; the overwhelming inference was that the owners authorized the scuttling.

[3.10] In closing, reference is made to another typical case that is also worthy of careful study: *Grave v GA Bonus*,[24] which clearly shows the critical importance of placing the persuasive chain of evidence before the court which allows the insurers when pleading fraud to discharge the burden of proof that is upon them.

The insured owned a hotel and insured it with GA in respect of damage caused by fire, including intentional arson by a third party in the absence of collusion or authorization by the owner. Following the occurrence of a serious fire which caused extensive damage to the hotel, the investigating fire officer formed the view that the fire had been started deliberately. Items examined in the aftermath of the fire suggested that a burglary had been attempted but had not, for some reason, been completed. There were marks on the door which were not consistent with having been made by forcing the fire door from outside the hotel. The insured claimed the indemnity under her insurance policy, but the insurer refused to indemnify the insured on the grounds that the fire had been started by or on behalf of the insured and that a break into the hotel had been engineered in order to suggest that the fire had been started by intruders. The insurer argued that the claim was fraudulent, motivated by the poor financial state of the hotel business and little prospect of any improvement in the future. The court was called upon to decide (1) whether the fire was started deliberately; (2) if so, was it started by or at the authorization of insured, and (3) whether a third party broke into the hotel undetected and started the fire.

The issue at trial was whether the insurers had satisfied the standard of proof that was required in the case and whether the insurers had eliminated all other possible causes so that the only realistic explanation was that of arson or whatever defence was relied upon. It was clear in giving the judgement that the burden of proof rested with the insurers and that a high burden remained. A combination of evidence was provided including critical financial evidence and this was deemed persuasive. There was significant physical evidence and whilst attempts had been made by the insured to simulate a point of entry to give a false impression that a burglary had been committed, this simulated point of entry in itself meant that there was no other credible explanation other than a simulated break-in was connected with the fire. All the evidence were considered by the court to point towards the insured as opposed to

[24] [1999] 2 Lloyd's Rep.716

a third party being responsible for starting the fire. The conclusions were that the fire was started deliberately and that acts were carried out to suggest that the fire had been started by a third party. The issue in relation to cause turned entirely upon evidential points and was supported by financial examination.

III. Fraud Indicators

[3.11] Although fraudulent claims are presented in various forms, there are some warning signs surrounding the circumstances which may suggest the possibility of fraud. However, the insurers must be fully aware that those signs, also called fraud indicators, provide no definite proof that a fraud has been actually committed. It only means further enquiries or investigations may become justified and necessary. In other words, understanding insurance fraud indicators is vital but fraud indicators should never be used as the legal basis for denying a claim – that should only be done based on the law, the evidence, and the facts. Rather, the real value of fraud indicators is to identify suspected fraudulent claims so that investigative resources can be reasonably allocated and targeted on the most deserving cases.

In the case of *The Milasan*,[25] the facts of which were summarized earlier, some fraud indicators could be picked up from the fascinating analysis of Aikens J and introduced as follows:

A. The forgetfulness of the key witnesses and inconsistencies between the stories and actions of the witnesses

[3.12] The principle of orality is one of the traditional foundations of the contested trail in common law system of adjudication,[26] thus a great significance has been attached to the witnesses testimony. A witness may be challenged on numerous grounds, but at the end of the day all the questions can just be refined to two points: is

[25] [2000] 2 Lloyd's Rep.458

[26] See Dennis, I, *The Law of Evidence*, 3rd edn, Sweet&Maxwell (2007), Chapter 1

the witness lying? And is the witness mistaken? Any witness can be deemed as suspect witness if his evidence can be challenged on the basis that there is a plausible reason for regarding his evidence as lying or mistaken.[27] In fraud cases, one of the techniques for determining whether the witness is suspect is to find out the contradictions in his testimonies and proceed with great cautions as to the decisions of paying the claim. Some practical examples could be found in the case of *The Milasan.*

(a) As a key witness on the casualty happened to the sinking ship, the captain simply claimed and reiterated that he could not remember things, which might just be an easy way to disguise his wrongdoings. For example, he could not remember why the manuscript report to the manage of the ship was changed by tippexing out "starboard" and replacing it with "PORT"; he could not explain why no bilge alarm had sounded when water got into the aft bilges (he alleged that the alarm was defective but the fact was the alarm was just tested and found satisfactory); nor could he explain why he did not take the ship's log book as opposed to those he did take.[28]

(b) The evidence given by crew members was contradictory and confusing. For instance, the engineer gave conflicting evidence about the number of bilge alarm panels; the deckhands said that he was sent forward by the master to check the bilges beneath the owners' cabin but there were no bilges beneath that cabin as the master must have appreciated; and the evidence about where or how the water was entering into the engine room was varied.[29]

(c) In the usual circumstances, "when a master losses his ship, if it is honestly lost he is deeply concerned to vindicate his seamanship and to maintain his character".[30] The master will think it is "necessary in the face of such a casualty to make an immediate and full statement to his owner."[31] However, in *The Milasan,* where there was enough time and facilities, the master did not get in touch with the owner until the following day, and Aikens J was of the

[27] *Ibid.*, 15.37

[28] *Ibid.*, 496

[29] *Ibid.*, 486-487

[30] *The Olympia* (1924) 19 LIL.Rep.255, 259

[31] *Ibid.*

opinion that "this failure points to the fact that the master had no need to tell that the vessel had sunk because that was what was expected".[32]

B. Missing of the important documents

[3.13] It is submitted that "where a master has lost his ship at a moment fraught with risk to his professional career and therefore to a seaman of a time of incredible anxiety, his first deep concern is to establish his integrity by reference to the ship's papers".[33] However, in *The Milasan*, the captain failed to take the ship's log, which is the most important record containing the details of the vessel's navigation, her position and weather conditions on the voyage that a master would normally wish to retrieve from a sinking vessel. The master managed to get a pile of documents including the crews' passports, documents relating to the purchase of fuel and the vessel's cash-box, which mean he could have time to get the log, but he had failed and could not provide a convincing explanation for it.

C. Financial motivation or distress[34]

[3.14] After finding that the owner of the vessel admitted that the yacht was too old, too slow and he wanted a new one; he had been unable to sell her at the price he wanted and she became a wasting asset as the maintaining was getting very expensive; if the insurance claim was successful he would be the sole beneficiary of the claim, Aikens J was of the opinion that the owner "did have a motive to sink the yacht".[35]

It is to be noted that in *The Milasan*, the owner was a rich man. Financial distress might be more obvious indictor pointing to the potential fraud: is there evidence of financial trouble such as unemployment, divorce, a failing business, or a looming foreclosure? However, in and of itself, financial distress proves nothing as to the legitimacy of the actual claim under scrutiny.

---

[32] [2000] 2 Lloyd's Rep.458, 497

[33] *The Olympia* (1924) 19 LIL.Rep.255, 259

[34] It should be noted again that motive is not an essential element of fraud but merely performing the evidential function of proving fraud. See Chapter One, at [1.32]

[35] [2000] 2 Lloyd's Rep.458, 497

By way of comparison, in *The Michael*,[36] a scuttling case the facts of which has been briefly stated above,[37] when considering whether the thought of scuttling the ship had crossed the owner's mind, one of the reasons given by the learned judge was that from the point of view of the business of ship-owning and ship-managing, which the owner was only just beginning to build up, and from the point of view of his reputation in the financial and insurance markets, the last thing which he would have wanted was a total loss. He was to some extent staking his reputation on the making a success of the ship. The court was of the opinion that on the balance of probabilities the thought of scuttling the vessel never crossed the owner's mind at all.[38]

D. Similarities with the typical fraudulent cases

[3.15] It was summarized that in a typical case as to fraudulent sinking of the vessel, "ships sank in deep water, where nothing could be ascertained by divers as to how the water got into them, but near enough to the shore and the track of ships for the crew to be quite safe, and in calm weather which caused no danger to the crews",[39] and those are indeed very similar to the facts of *The Milasan*. The incident occurred during summer time when the weather was calm and warm. The vessel started to sink three hours before nightfall, so the timing could be said to be consistent with a deliberate sinking. The vessel was within 25 miles of land so the danger of crew being left to the sharks or the dogfish (as the master put it) was minimal.

[3.16] Besides what has been listed above, there are some other "red flags" which may constitute a guideline or checking list to alert the insurers about some potential fraudulent claims.[40]

---

[36] [1979] 1 Lloyd's Rep.55(High Court); [1979] 2 Lloyd's Rep.1(Court of Appeal)

[37] See Chapter Two, at [2.12]

[38] [1979] 1 Lloyd's Rep.55, 74

[39] *The Leonita* (1922) 13 Ll.L. Rep. 231, 246–247

[40] See Robert Scott, *Insurance Fraud Indicators*, available at http://www.crimetime.com, accessed on 3rd April 2012.

E. Prior claim history

[3.17] The question is: does the claimant have an extensive history of making prior insurance claims? One common pattern is a history of claims with increasingly greater value. It's as if the perpetrator is inching out into deeper and deeper water to see how far he or she can go, one claim at a time. Commonly, the very first claim will have been legitimate. Unfortunately, this legitimate claim can serve as an ice breaker to educate the perpetrator on how to milk the system.

F. New policy claim

[3.18] If the claim is made on a new policy, the ink of which has barely dried, the attention of the claim handlers might be attracted and there is possibility that a fraud investigation will be opened.

G. Coverage inquiry

[3.19] A potential fraud might be committed if a recent request from insured for coverage increase is not justified by betterments. An example is *Wood v Associated National Insurance Co Ltd*:[41] after leaving the ship, the insured did nothing but called his insurers to increase the coverage.

[3.20] To sum up, first of all, it shall be borne in mind that the above list is non-exhaustive and secondly it shall be stressed again that fraud indicators are just symptoms or characteristics of possible fraud. An indicator may be caused by the fraudulent act itself or result from an attempt to hide the fraudulent schemes. Some indictors may, in and of themselves, suspicious enough to trigger a further investigation but in most circumstances, the whole picture must be considered and the interrelationship of several seemingly unrelated deficiencies or indictors must be combined in order to promote successful investigations.

[41] [1985] 1 Qd R 297. See Chapter Two, at [2.11]

CHAPTER FOUR

THE EVALUATION ON VARIOUS REMEDIES FOR PRESENTATION OF FRAUDULENT CLAIMS

My object all sublime
I shall achieve in time —
To let the punishment fit the crime —
The punishment fit the crime;
And make each prisoner pent
Unwillingly represent
A source of innocent merriment!
Of innocent merriment!

——Gilbert & Sullivan, *Mikado*, *"A more humane Mikado"*

Introduction

[4.1] Within the last two decades particularly after the judgement of *The Star Sea*[1] was delivered, the search, judicially or extra-judicially, for the appropriate remedy available for the presentation of fraudulent claims by insured has never stopped, but the outcome is far from satisfactory. The current position of law was described by Professor Thomas as one of the "substantial uncertainty", there being "little that is settled and certain about the present law. It is truly a body of law in a state of flux."[2]

---

[1] [2001] 1 Lloyd's Rep.389

[2] Thomas, DR, *Fraudulent Insurance Claims: definition, consequences and limitations* [2006] LMCLQ 485, 515

[4.2] In *The Star Sea,*[3] it has been confirmed that the duty of good faith continues at post-contractual stage, but it can only be breached by fraudulent conduct. There is no doubt that the fraudulent claims shall be rejected, but the difficulty arises in relation to

(1) The precise ambit and outcome of entitlement of rejection;

(2) The effect of fraudulent claim on validity of existing policy; and

(3) The availability of other remedies.

[4.3] Three possible analytical routes have been found:

(1) A common law rule of forfeiture relating to fraudulent claims, which was identified by the judicial authority in the late 19th century;

(2) General contractual principles (express terms and implied terms);

(3) The principle reflected in Section 17 of the Marine Insurance Act 1906, leading to avoidance *ab initio.*

The difficulty enumerated above will be evaluated and answered during the scrutiny on these three paths and the relationships between the three ways will also be probed into in the following sections.

I. The Common Law Rule of Forfeiture

A. Introduction

[4.4] It is free from difficulty that at common law, the insurer is entitled to reject a claim which is fraudulently submitted. Dating back to 1858, in *Goulstone v Royal*

[3] [2001] 1 Lloyd's Rep.389

Insurance Company,[4] the insured's property was destroyed by fire and he submitted his claim to be more than £200, whereas in earlier insolvency proceedings, the same property was declared to be worthy of £50. Pollock CB directed the jury that the claim was fraudulent if "it was wilfully false in any substantial respect" and "if the claim was fraudulent the plaintiff cannot recover".[5]Later in *Britton v Royal Insurance Company,*[6] the insured's property was destroyed by fire, the claim was declined by insurer on the basis of both arson and fraud in the sense that the insured had set fire to his house, and had presented a claim which was greater than it actually was. Willes J summed up the legal principles and directed the jury:[7]

> "Of course, if the assured set fire to his house, he could not recover. That is clear. But it is not less clear that, even suppose that it were not willful, yet as it is a contract of indemnity only, that is, if the claim is fraudulent, it is defeated altogether...This is a defence quite different from that of wilful arson. It gives the go-by to the origin of the fire, and it amounts to this-that the assured took advantage of the fire to make a fraudulent claim. The law upon such a case is in accordance with justice, and also with sound policy. The law is that a person who has made such a fraudulent claim could not be permitted to recover at all. The contract of insurance is one of perfect good faith on both sides, and it is most important that such good faith should be maintained. It is the common practice to insert in fire-policies conditions such that they shall be void in the event of a fraudulent claim; and there was such a condition in the present case. Such a condition is only in accordance with legal principle and sound policy. It would be most dangerous to permit parties to practice such frauds, and then, notwithstanding their falsehood and fraud in the claim, to recover the real value of the good consumed. And if there is wilful falsehood and fraud in the claim, the insured forfeits all claim upon the policy. This is, therefore, was an independent defence; quite distinct from that of arson"

[4.5] It is submitted that this right to reject at common law has a distinct origin and history, arising independently of contract or the existence of an express fraudulent

[4] (1858) 1 F&F 276

[5] *Ibid.*, 279

[6] (1866) 4 F&F 905

[7] *Ibid.*, 909

claims clause or indeed on the principle of utmost good faith.[8] The position and the underlying policy were clearly summarized by Lord Hobhouse in *The Star Sea*:[9]

> "Where an insured is found to have made a fraudulent claim upon the insurers, the insurer is obviously not liable for the fraudulent claim...The law is that the insured who has made a fraudulent claim may not recover the claim which could have been honestly made. The principle is well established and has certainly existed since the early 19th century...This result is not dependent upon the inclusion in the contract of a term having that effect or the type of insurance; it is the consequence of a rule of law...The logic is simple. The fraudulent insured must not be allowed to think: if the fraud is successful, then I will gain; if it is unsuccessful, I will lose nothing."

There may be some conceptual difficulty in applying the reasoning of Lord Hobhouse strictly to the cases in which fraudulent means or devices are employed because where the use of fraudulent devices occurs, the whole claim is by definition otherwise good. However, the courts did not intend to make such a pretty distinction. In *Agapitos v Agnew*,[10] the question was raised for consideration whether as a matter of policy the underlying rationale of the fraudulent claim principle should extend to invalidate not merely the whole of a claim that is partly good, but the whole of a claim where the whole proves otherwise good. Mance LJ was of the opinion that the effect of the fraudulent claim principle is: once it is determined that part of a claim is false, the rest is forfeited, without it being necessary to determine whether or not that rest itself relates to genuine loss. Similarly, once the use of fraudulent devices constitutes a defence to a claim, the possibility arises that this might be established by a preliminary issue, making the trail of further issues irrelevant, so that, it might never be determined whether genuine loss is suffered.[11] Thus, the same consequence follows.

---

[8] Thomas, DR, *Fraudulent Insurance Claims: definition, consequences and limitations* [2006] LMCLQ 485,503

[9] [2001] 1 Lloyd's Rep.389, [62]

[10] [2002] 2 Lloyd's Rep.42

[11] *Ibid.*, [19]

B. *AXA General Insurance Ltd v Gottlieb*:[12] the scope and effect of the common law rule

[4.6] The scope and effect of common law rule handling fraudulent claim were examined in detail again by the Court of Appeal in *AXA General Insurance Ltd v Gottlieb,* which is probably worthy of exploring at some length.

The insureds Mr. and Mrs. Gottlieb obtained a building policy from AXA for the year commencing 31 August 1993. During a one year period the insureds made four claims: Claim 1 was made in December 1993 and concerned dry rot damage; Claim 2 was made in February 1994 for damage following an escape of water in a bathroom; Claim 3 in July 1994 was for storm damage and Claim 4 in May 1994 concerned a further escape of water in another bathroom. AXA subsequently asserted that insured had been guilty of two instances of fraud. In September 1999, in respect of the first loss, the insureds had submitted a claim for the costs of alternative accommodation incurred while the dry rot was being repaired. In June 2000, they had further knowingly submitted a forged invoice for electrical work in support of the second claim. No allegations were made in respect of Claims 3 and 4, both of which had been paid in full before the allegedly fraudulent acts had been committed.

By judgment dated 7 May 2004, the High Court held that insured had been fraudulent in respect of Claim 1 from late September or early October 1999 and in respect of Claim 2 from 20 June 2000. By September/October 1999, AXA had already paid over £30,000 for repairs plus £4,500 for alternative accommodation on Claim 1 and £14,250 on Claim 2. Subsequently, and before discovering the fraud, they paid a further £9,406 for repairs and over £16,000 for alternative accommodation on Claim 1. No further payments were made on Claim 2. Insurers brought proceedings to recover all payments made in respect of all four claims. At first instance, the judge held that the first two claims were tainted by the fraud, but that Claims 3 and 4, which were genuine and had been paid before any fraud was committed, should stand.

The insureds initially appealed that the only sums that they were liable to repay were those paid by AXA after the fraud: the earlier payments for the first two losses

[12] [2005] Lloyd's Rep.IR 369

were only interim payments and untainted by any subsequent fraud. AXA cross-appealed against the judge's ruling that they were not allowed to recover the sums paid in respect of the genuine claims.

The insurers in this case were not seeking to rescind the whole policy *ab initio* or relying on any general principle reflected in Section 17 of the Marine Insurance Act 1906. Nor did they resort to the general contractual principle that might have entitled them to treat the insurance as at the end or repudiated for the future given that the policy had long expired by the time of AXA's restitutionary claim. This appeal, therefore, was solely on the ground of common law and concerned with the scope and effect of the common law rule in relation to: (1) Genuine, separate claims made under the same policy but paid in full before any wrongful act was carried out (Claims 3 and 4); (2) Claims, part genuine, part fraudulent, where interim payments of genuine parts of the claims had been made before the fraudulent acts were committed (Claims 1 and 2).

[4.7] With regards to Claims 3 and 4, the Court of Appeal agreed with the High Court that they should be upheld. Mance LJ could see no basis for giving the common law rule retrospective effect on separate claims under the same policy that had already been paid before any fraud occurred. In addition, there was no need in this case to consider the position where a separate, genuine claim had not yet been paid by the time of the fraud. Mance LJ, however, found some force in the argument that the common law rule "should be confined to the particular claim to which any fraud relates".[13] If this comment is recognized, the consequence would be that a genuine claim make before a fraudulent claim would remain payable despite the intervening fraudulent claim.

The key question was in respect of Claims 1 and 2: whether the insurers could recover interim payments in respect of genuine losses made prior to any fraud connected with the same claim. The insured argued that the common law rule only had effect from the date of the fraud. In other words, after an act of fraud had been committed, the insured could not thereafter recover in respect of any part of the claim,

[13] *Ibid.*, [22]

but the payments made prior to the fraud and in respect of genuine loss were unaffected. Mance LJ disagreed. For the purpose of comparison, his Lordship examined a series of persuasive authorities in details:[14] first of all, in the case of the use of fraudulent devices or means to promote a genuine claim, insurer is entitled to reject the whole claim; secondly, in the case of initially honest claim being fraudulently inflated at a later stage, the insured is at peril of losing the whole claim; and thirdly, a claim that is fraudulent in any substantial part is invalid as a whole, and the insurer is entitled to recover all the money paid under the claim. The entitlement on the part of insurer does not depend upon showing that the contract is rendered void *ab initio* due to the commission of fraud. Thus, the insured in the present case may not only be rejected to get indemnity related to the whole claim, but also has to repay any sum by way of indemnity in respect of such loss before the fraud is even committed.[15] His Lordship was also of the opinion that the insured was seeking to reduce the severity of a rule that was deliberately designed to operate in a draconian and deterrent fashion: [16]

> "The policy of the rule is to discourage any feeling that the genuine part of a claim can be regarded as safe - and that any fraud will lead at best to an unjustified bonus and at worst, in probability, to no more than a refusal to pay a sum which was never insured in the first place"

[4.8] Accordingly, it may be concluded that if a fraud is committed in respect of an otherwise genuine claim which has already accrued but not been paid, the whole claim is forfeited. Interim sums paid towards a claim are made on the assumption that an obligation to indemnify exists or will arise. If the whole claim later becomes forfeit, then any such payments cease to have any basis and are recoverable by insurers, either because they are made on a false premise, or for consideration which wholly fails.

---

[14] *Ibid.*, [23]. Those authorities included *The Star Sea, Agapitos v Agnew, and Direct Line Insurance v Khan.*

[15] *Ibid.*, [26]

[16] *Ibid.*, [31]

C. *Super Chem Products Ltd v American Life and General Insurance Co.Ltd.*:[17] the relationship between common law rule and other contractual defence in the insurance policy

[4.9] The common law rule does not expressly identify the influence of rejection or forfeiture of the whole claim upon the continuing validity of the insurance policy, so a further problem which ought not to be ignored is the relationship between the common law rule and other contractual defences available to the insurer in an insurance policy e.g. the time bar clause, the co-operation clause: whether or not common law rule has any impact upon the enforcement of these entitlements.

[4.10] In *Jureidini v National British and Irish Miller Insurance*,[18] a case decided almost a century ago, an insurance company disputed liability of a claim by an insured, arising out of a fire, on the grounds of fraud and arson. At trial these allegations were found to be unsustainable. The insurer then sought to avoid liability on the basis that, by litigating, the insured was in breach of an arbitration clause in the policy. The arbitration clause applied only "if any difference arises as to the amount of any loss or damage" and provided that "it shall be a condition precedent to any right of action or suit upon this policy that the award by such arbitrator, arbitrators or umpire of the amount of the loss or damage if disputed shall be first obtained". The House of Lords held that the insurance company was not entitled to rely on the arbitration clause. The main reason was that the condition to trigger the clause was not satisfied, but Viscount Haldane, *obiter*, said the claim was tainted by fraud and all the benefits in relation to claim were forfeited, and "when there is a repudiation which goes to the substance of the whole contract I do not see how the person setting up that repudiation can be entitled to insist on a subordinate term of the contract being enforced."[19]

[17] [2004] UKPC 2; [2004] 2 ALL ER 358

[18] [1915] AC 499

[19] *Ibid.*, 505

[4.11] The reasoning given by Viscount Haldane, if accepted, will lead to an unsatisfactory solution, namely an insurer who repudiates liability on the grounds of fraud cannot insist on a subordinate term of contract still being enforceable. However, the position was correctly rejected by Privy Council in *Super Chem Products Ltd v American Life and General Insurance Co.Ltd.* [20]

In this case, the insurer agreed to insure the insured *Super Chem Products Ltd*, under the terms of two Collective Fire and Special Perils Insurance Policies namely: (a) the stock policy, which provided cover against loss and damage to stocks and stores at the premises; (b) the consequential loss policy, which provided cover against business interruption and other losses consequent upon the loss of, or damage to, stocks and stores at the premises. The insured submitted the claims under the two policies after a fire destroyed large parts of the insured's premise, but the insurer denied the claim on numerous grounds (a) the fire was caused by arson and with the connivance or complicity of the insured; (b) the insured was in breach of co-operation provisions of the two policies; (c) the notices of the claims were not given in time and the claims were not presented within the time limits provided by the policy.

The counsel for the insured, relying upon the decision of *Jureidini*, argued that because the insurers had alleged arson they were not entitled to rely on the limitation provisions and claims co-operations provision in both policies. This submission was rejected by Lord Steyn, who delivered the leading judgement of the Board.[21] His Lordship, from the points of view of general contract law, summarized that (1) the insurers' defence of arson was not a repudiation of the contract but rather a defence based on the contract. Contract law cannot and does not prevent an insurer from resisting a claim on alternative bases, one involving an allegation of fraud and the other breaches of policy conditions. It would be contrary to the principle and the business common sense, which underpin the commercial law, to require an insurer to choose between alleging fraud, thereby abandoning the right to invoke other conditions of the policy, or to rely on those provisions, thereby giving up the right to allege fraud; (2) In *Photo Production Ltd v Securicor Transport Ltd*[22] the House of

[20] [2004] UKPC 2; [2004] 2 ALL ER 358

[21] *Ibid.*, [11]-[20]

[22] [1980] AC 827

Lords held that a fundamental breach, whilst bringing to an end primary obligations under the contract, does not necessarily bring to an end secondary obligations, such as exclusion clauses. Whether or not the secondary obligations survive is a matter of construction.[23] Accordingly, The House concluded that Viscount Haldane's approach shall not be maintained anymore.

[4.12] To sum up, fraud in the presentation of claim leads to the forfeiture of the insured's rights against the insurer regarding the particular loss for which the claim was made, but while fraud may be difficult to prove, the insurer is in any event entitled to rely on the alternative contractual defences based upon the provisions of insurance policy.

D. Conclusions

[4.13] The independent common rule dealing with fraudulent claims is relatively certain, compared with other aspects of legal rules in this area. The current positions could be summarized as follows:

(a) The submission of fraudulent claim should entitle the insurer to reject the whole claim in relation to which the fraud is committed, but not entitle the insurer to reject any other separate claim.

---

[23] With regard to arbitration clause in particular, in pursuant to the principle of separability of arbitration agreement affirmed by Section 7 of Arbitration Act 1996 which says that "unless otherwise agreed by the parties, an arbitration agreement which forms or was intended to form part of another agreement (whether or not in writing) shall not be regarded as invalid, non-existent or ineffective because that other agreement is invalid, or did not come into existence or has become ineffective, and it shall for that purpose be treated as a distinct agreement.", it may be concluded that when there is a repudiation which goes to the substance of the whole contract and bring the primary obligation to the end, the arbitration clause is as a matter of law severable from the main obligation and stands or falls in its own right. Accordingly, if *Jureidini* case was decided today, the result might have been different. (The concept of severability was not fully recognized in England until the 1993 decision of Steyn J, affirmed by the Court of Appeal in *Harbour Assurance Co (UK) Ltd v Kansa General International Insurance Co Ltd* [1993] 1 QB 701) See Merkin, R & Flannery, L, *Arbitration Act 1996*, 4th edn, LLP (2008). See also *Fiona Trust & Holding Corp v Privalov* [2008] 1 Lloyd's Rep.254

(i) Where a claim is initially submitted on an genuine basis, and a payment on account is made, but then in the final presentation of the claim there is fraudulent element, e.g. fraudulent devices are used to promote the claim, the whole claim would be rejected and the interim payment made previously could be recovered back by the insurers;

(ii) However, if the insured has an entirely separate claim, in relation to which there has been no fraud committed, and with regard to which he has not yet been paid at the time when the fraud is committed in relation to another claim, then the insured will remain entitled to payment in respect of the honest claim. One of the important justification for this proposition is stated by Australia Law Commission in its report regarding the reform of Australia insurance contract law ALRC Report 20: "where fraud must be discouraged, the rule that fraud in respect of one claim taints other claims under the same policy can operate most unevenly between an insured with a number of separate policies and one with a composite policy covering numerous risks."[24]

(iii) The date of payment is actually irrelevant to the question.

(b) The current law takes the position no further on perhaps a key outstanding question, namely whether a fraudulent claim entitles the insurers to bring an end to the policy. In other words, whether, if the insured suffers a genuine loss even in the period after the commitment of the fraud and he commits no fraud in relation to the claim for this separate loss, the insurers have the right to refuse to pay the later claim. Mance LJ's analysis focused on the claim itself not the policy, so the answer of this question at present is unclear. Nevertheless, relying upon the common law rule to defeat the fraudulent claim will not deprive the insurers of other contractual defence available under the insurance policy.

(c) Perhaps the same as the post-contractual duty of utmost good faith under Section 17 of Marine Insurance Act 1906 no longer exists once the litigation starts, the common law rule will only apply before the commencement of court or arbitration

[24] ALRC Report 20, [243], http://www.alrc.gov.au/report-20, accessed on 4th April 2012

proceedings.[25] Some judicial doubts are casted on this conclusion because there may be no justification for the law adopting a different attitude to fraud at one time rather than another, as Simon J said in *The Game Boy*:[26]

> "What is said by the insurer is that, even if the assureds had a valid claim, the claim must fail because the assureds have used fraudulent devices to promote the claim. The rule is in some ways anomalous since it only applies between the making of the claim and the start of litigation. After litigation has commenced an insured may advance false documentation and lie without the drastic consequences which follow if the deployment of false documentation and lies are less well timed."

Nevertheless, the rule is presently well-established. So if the insured puts forward a claim, abstains from any kind of dishonesty then commences an action and only then creates fraudulent documentation in support of that claim e.g. in order to maximize his chances of success, the insurer cannot rely on common law rule to defend that claim. In addition, in the light of the decision in *Direct Line Insurance Plc v Fox*,[27] the common law rule may not be invoked after the parties have entered into a binding compromise settlement contract, in the sense that any fraud committed for the purpose of the fulfillment of the compromise settlement contract may not entitle the insurer to reject the claim.[28]

---

[25] In *Agapitos v Agnew* [2002] 2 Lloyd's Rep.42, [52], Mance LJ was of the opinion that the same policy considerations that let Lord Hobhouse to restrict the duty of good faith to the pre-litigation period militate strongly in favour of a similar restriction of the duration of the common law duty. The position, however, is not clear whether common rule would cease to function after the claim is settled. In *The Buana Dua* [2011] EWHC 2413 (Comm), a positive argument was raised, proposing that common law rule is different from the duty of utmost good faith and, therefore, would not cease when the compromise agreement is reached. The court did not decide this point in the case. See Chapter Two, at [2.38]

[26] [2004] 1 Lloyd's Rep.238, [150]

[27] [2009] EWHC 386 (QB). See Chapter Two, at [2.33]

[28] This point was raised in *The Buana Dua* [2011] EWHC 2413 (Comm), but was not decided by the court. See Chapter Two, at [2.38]

II. The Fraudulent Claims Clauses

A. Introduction

[4.14] Party autonomy is well considered as one of the fundamental values of commercial transaction law including insurance law save being subject to the public police.[29] It is also firmly established that the classical law of contract is based on freedom of contract[30] and sanctity of contract and accordingly, the parties should be free to choose their own terms, subject to the restrictions imposed by both common law (e.g. restriction on illegal contracts) and statute (e.g. Unfair Contract Terms Act 1977), and the task of the court is to give effect to the agreement that the parties have concluded.[31] There are no justifiable reasons why the law of commercial insurance contract should not follow this pattern.[32]

---

[29] Bennett, H, *Reflections on Values: the Law Commissions' Proposals with respect to Remedies for Breach of Promissory Warranty and Pre-formation Non-disclosure and Misrepresentation in Commercial Insurance*, Chapter 8 of *Reforming Marine and Commercial Insurance Law,* Soyer, B(Ed), Informa (2008). It is submitted in this article that party autonomy, certainty and appropriateness of remedy are the three fundamental values of commercial transactions law.

[30] Lord Diplock observed in the case of *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827, 848: "A basic principle of common law of contract…is that the parties are free to determine for themselves what primary obligations they will accept."

[31] See Adams & Brownsword, *The Ideologies of Contract Law* (1987) 7 Legal Studies 205, 206-211

[32] The concept of freedom of contracts has received several inroads as the result of the developments in modern economic and social life. However, for the purpose of current discussion, it is suggested that freedom of contracts still plays a reasonable and significant role in the sense that in commercial insurance transactions the equality of bargaining power between the insured and insurer can be assumed, and no injury is done to the economic interests of the community at large. See Beatson, J & Burrows, A & Cartwright, J, *Anson's Law of Contract*, 29th edn, Oxford (2010), 4-7.

Accordingly, it makes perfect sense that the parties to commercial insurance contract expressly agree the consequences and remedies for committing fraud in claims, as Lord Hobhouse described in *The Star Sea*:[33]

> "On ordinary contractual principles it would be expected that any question as to what are the parties' rights in relation to anything which has occurred since the contract was made would be answered by construing the contract in accordance with its terms, both express and implied by law. Indeed, it is commonplace for insurance contracts to include a clause making express provision for when a fraudulent claim has been made."

[4.15] In *Reid & Co., Limited v Employers' Accident, &c., Insurance Co., Limited*,[34] the policy in question contained a clause stating that "Any fraudulent misdescription in the particulars furnished by the insured shall render this policy void." The court summarized the purpose of this clause, saying that: "the clause in the proposal protected the company from being bound at any time or to any effect by a contract induced by statements that were untrue in point of fact; the clause in the policy protected the company against fraud when the obligation which the policy imposed upon them was sought to be enforced."[35] It is believed that this is the prevalent target for the insertion of similar clauses into the policy.

[4.16] Discovery of the protection of express conditions in insurance policy against fraudulent claims is a long-history practice.[36] In the 18th century it was common to find a clause requiring the insured to procure a

> "certificate under the hand of the minister and churchwardens, together with some other reputable inhabitants of the parish…importing that they were well acquainted with the character and the circumstances of the person...insured and do know or verily believe

---

[33] [2001] 1 Lloyd's Rep.389, [61]

[34] (1899) 1 F 1031

[35] *Ibid.*, 1037

[36] See Legh-Jones, N, (Ed), *MacGillivray on Insurance Law*, 11th edn, Sweet&Maxwell (2008), 19-056

that he she or they really and by misfortune without any fraud or evil practice have sustained the claimed loss or damage by fire".

This could work hardship if the insured could not produce a certificate and the requirement for such a certificate was expressed to be a condition precedent to liability. By the early 19th century it was more usual to find a clause in these terms: "If there appears fraud in the claim made, or false swearing or affirming in support thereof, the claimant shall forfeit all benefit under the policy." Some examples of expressly drafted provisions dealing with fraudulent claims in the 20th and 21st centuries can be provided as follows:

Example (A):[37] If the assured shall make any claim knowing the same to be false and fraudulent, as regards amount or otherwise, the policy shall become void and all claims here under shall be forfeited.

Example (B):[38] If the claim be in any respect fraudulent or if any fraudulent means or devices be used by the insured or anyone acting on his behalf to obtain any benefit under this Policy...all benefit under this policy shall be forfeited.

Example (C):[39] This policy will be rendered void in the event of ...any misrepresentation or fraud committed in making or supporting any claim hereunder...

Example (D):[40] We will at our option avoid the policy from the inception of this insurance or from the date of the claim or alleged claim or avoid the claim (a) if a claim made by you or anyone acting on your behalf to obtain a policy benefit is fraudulent or intentionally exaggerated, whether ultimately material or not or (b) a false declaration or statement is made or fraudulent device put forward in support of a claim.

---

[37] *Lek v Mathews* (1927) 29 Ll.L.Rep.141

[38] *Insurance Corp of the Channel Islands v McHugh and Royal Hotel Ltd* [1997] LRLR 94

[39] *Roberts v Avon Insurance Company Ltd* [1956] 2 Lloyd's Rep.240

[40] *Joseph Fielding Properties (Blackpool) Limited v Aviva Insurance Limited* [2010] EWHC 2192 (QBD)

B. Interpretation of clauses and consequences of breach

[4.17] English Law gives the parties considerable freedom to define their rights and liabilities. However, it is also the case that any given contract provisions can always be challenged, *inter alia*, as to its precise meaning in the light of established interpretation principles. This was expressed by Hobhouse J in *EE Caledonia Ltd. v Orbit Valve Co Europe* in a categorical fashion:[41]

> "It has to be borne in mind that commercial contracts are drafted by parties with access to legal advice and in the context of established legal principles as reflected in the decisions of the courts. Principles of certainty, and indeed justice, require that contracts be construed in accordance with the established principles."

[4.18] The wording of fraudulent claims clauses used in London market has scarcely varied for 200 years. The most commonly encountered clauses is the one in Lloyd's J and J (A) Forms, which is listed as Example (A) above, providing that if the insured makes any claim knowing that it is false and fraudulent, the policy becomes void and all claims are to be forfeited. However, the meaning of phrase "the policy becomes void and all claims are to be forfeited" is not clear and there is no direct authority on how the clause should be construed. In addition, the standard market clause provides that the duty not to commit fraud could be a condition precedent to the payment of claim, and theoretically, it is also possible that the parties may stipulate that it is a warranty in the policy not to submit fraudulent claims. Therefore, the following sections will explore and clarify the potential implications of those four different terminologies in the context of fraudulent claim clauses: void/avoid, forfeited/forfeiture, condition precedent, and warranty.

(a) Void/Avoid

[4.19] In the context of general contract law, when it is said that a contract is void, the basic position is that "such contract is simply one which the law holds to be no contract at all, a nullity from the beginning. The parties would be in the same position

[41] [1993] 4 ALL ER 165, 173

as they would have been had the contract never been made".[42] In short, the contract is of no legal effect at all from the beginning. A similar conclusion seems to follow in insurance context. When Lord Mansfield described good faith and the duty of disclosure in the insurance relationship in *Carter v Bohem*,[43] he said: "the keeping back in such circumstances is a fraud, and therefore the policy is void. Although the suppression should happen through mistake, without any fraudulent intention; yet still the underwriter is deceived, and the policy is void."[44] Twelve years later in *Pawson v Watson*,[45] he emphasized that the avoidance of the contract was as the result of a rule of law: "But as, by the law of merchants, all dealings must be fair and honest, fraud infects and vitiates every mercantile contract. Therefore, if there is fraud in a representation, it will avoid the policy, as a fraud, but not as a part of the agreement." It seems that from those two short speeches, Lord Mansfield actually used the terminologies "void" and "avoid" in an interchangeable fashion and had no intention to distinguish the differences between them. In the modern context, it has been confirmed that both terms should refer to the voidability of the contract rather than automatic void of the contract. In other words, the contract would not become automatically ineffective but the injured party of the contract should have the option to rescind or affirm the contract. [46] In addition, both terms refer to the remedy that allows the setting aside of a contract *ab initio*, as if the contract had never been agreed.

---

[42] Beatson, J & Burrows, A & Cartwright, J, *Anson's Law of Contract*, 29th edn, Oxford (2010), 22

[43] (1766) 3 Burr 1905

[44] *Ibid.*, 1909

[45] (1778) 2 Cowp 786, 788

[46] In *Islington London Borough Council v Uckac* [2006] 1 WLR 1303, [26], Dyson LJ explained the difference between void and voidable terms as follows: "A contract which is voidable exists until and unless it is set aside by an order of rescission made by the court at the instance of a party seeking to terminate it or bring it to an end. A representee who has been induced by misrepresentation, whether fraudulent, negligent or innocent, to enter into a contract with the representor has, on discovery of the true facts, a right of election: he may affirm or disaffirm the contract: *Halsbury's Laws of England*, 4th ed, vol 31 (2003 reissue), para 784. If the representee affirms the contract, then he loses his right to rescind and the contract continues to have full force and effect. If he disaffirms and seeks to bring the contract to an end, the court may make an order of rescission, but in some circumstances will refuse to do so. If the contract is rescinded, then the contract is avoided ab initio: it is treated as if it never had effect. But that is not to say that, until it is rescinded, it does not have effect. "

The consequence could be harsh, but there is nothing in principle precluding the parties from agreeing avoidance of policy *ab initio* as remedy for breach, as Lord Hobhouse made it clear in *The Star Sea*[47] that:

> "The potential is also there for the parties, if they so choose, to provide by their contract for remedies or consequences which would act retrospectively."

[4.20] When the term "void" or "avoid" used alone without the qualification "*ab initio*", it may be argued that it is uncertain if this is to be interpreted as meaning avoidance *ab initio* or prospective avoidance.[48] The argument that the effect of avoidance could be prospective probably came from the speech of Lord Scott in *The Star Sea:*[49]

> "The presentation of a dishonest or fraudulent claim constitutes a breach of duty that entitles the insurer to repudiate any liability for the claim and, *prospectively* at least, to avoid any liability under the policy."

However, with great respect, it is submitted that the argument is not well-grounded, at least not yet, in the sphere of English insurance contract law.[50] The avoidance will not merely discharge the parties from further performance as from the time of breach. The true legal effect of avoidance is persuasively explained by Lord Hobhouse in *The Star Sea*:[51]

> "The right to avoid referred to in Section 17...applies retrospectively. It enables the aggrieved party to rescind the contract *ab initio*. Thus he totally nullifies the contract. Everything done under the contract is liable to be undone."

---

[47] [2001] 1 Lloyd's Rep.389, [61]

[48] Thomas, DR, *Fraudulent Insurance Claims: definition, consequences and limitations* [2006] LMCLQ 485, 501

[49] [2001] 1 Lloyd's Rep.389, [110]

[50] It shall be noted that, reading between the lines, Lord Scott was not committing himself to his speeches.

[51] [2001] 1 Lloyd's Rep.389, [51]

[4.21] Therefore, it seems that it has been established that "void/avoid" does not possess other legal meanings in the insurance context except "avoidance *ab initio*". As a general rule of interpretation, in consideration of certainty and continuity of commercial law, if the meaning of words used has been established by the authorities, then the latter courts have to follow that interpretation, as Waller LJ said In *British Sugar plc v NEI Power Projects Ltd* that:[52]

> "Once a phrase has been authoritatively construed by a court in a very similar context to that which exists in the cases in point, it seems to me that a reasonable businessman must more naturally be taken to be having the intention that the phrase should bear the same meaning as construed in the case in point. It would again take very clear words to allow a court to construe the phrase differently."

Furthermore, Lord Denning MR said that:[53]

> "Once a court has put a construction on commercial documents in a standard form, commercial men act upon it. It should be followed in all subsequent cases. If the business community is not satisfied with the decision, they should alter the form."

[4.22] Accordingly, if the words "void" or "avoid" or "avoidance" are used expressly in the clause, there are no justified reasons deviating from their legal meanings which have already been universally acknowledged. A possible objection is that such interpretation is unreasonable due to the harshness of the consequences of breach, may not be a commercially sensible interpretation and should be rejected accordingly, because "words ought to be interpreted in the way in which a reasonable commercial person would have construed them and the reasonable commercial person can safely be assumed to be unimpressed with technical interpretations and undue emphasis on niceties of language".[54] However, unreasonableness and lack of commercial sense are not the reasons of rejecting the adoption the natural meaning of "void/avoid". The danger that the notions of commercial sense being abused has

[52] [1997] 87 BLR 42,

[53] *The Annefield* [1971] 1 Lloyd's Rep.1, 3

[54] *Society of Lloyd's v. Robinson* [1999] 1 WLR 756, 763(Lord Steyn)

clearly been warned by Neuberger LJ in *Skanska Rasleigh Weatherrfoil Ltd v Somerfield Stores Ltd*:[55]

> "The court must be careful before departing from the natural meaning of the provision in the contract merely because it may conflict with its notions of commercial common sense of what the parties may must or should have thought or intended. Judges are not always the most commercially-minded, let alone the most commercially experienced, of people, and should, I think, avoid arrogating to themselves overconfidently the role of arbiter of commercial reasonableness or likelihood."

Neuberger LJ's approach was supported by the Supreme Court in a very recent case *Rainy Sky SA v Kookmin Bank*,[56] where Lord Clarke held that: "unless the most natural meaning of the words produces a result so extreme as to suggest that it was unintended, the court must give effect to that meaning".

Another way to justify the adoption of the natural meaning of "void/avoid" is that the principle of freedom of contract allows the parties to agree unreasonable terms as long as they make that free from ambiguities. This proposition has been put strongly by Lord Morris in *L.Schuler AG v Wickman Machine Tool Sales*:[57]

> "Subject to any legal requirements business men are free to make what contracts they choose but unless the terms of their agreement are clear a court will not be disposed to accept that they have agreed something utterly fantastic. If it is clear what they have agreed a court will not be influenced by any suggestion that they would have been wiser to have made a different agreement. If a word employed by the parties in a contract can have only one possible meaning then, unless any question of rectification arises, there will be no problem. If a word either by reason of general acceptance or by reason of judicial construction has come to have a particular meaning then, if used in a business or technical document, it will often be reasonable to suppose that the parties intended to use the word in its accepted sense. "

[55] [2006] EWCA Civ.1732, [22]

[56] [2011] UKSC 50, [21]

[57] [1974] AC 235, 255-256

[4.23] To sum up, although "it would be an improbable term for the parties to agree",[58] as long as the parties made them crystal clear, the intentions of parties should be respected and the relevant clauses should be given effect, albeit reluctantly. In *Kumar v Life Insurance Corporation of India*[59], Kerr J confirmed that a clause which expressly rendered the contract void and in addition the forfeiture of all the paid premium was perfectly valid, even in the absence of fraud, and could not be struck down on the basis that it was a penalty clause.

[4.24] If the wording of policy in question makes it crystal clear that in the case of fraudulent claims the insurer is entitled, at his option, to avoid the policy *ab initio* then the court will provide the judicial support to the insurer. This proposition has been judicially demonstrated in a recent case *Joseph Fielding Properties (Blackpool) Limited v Aviva Insurance Limited.*[60] The clause in question (Condition 7) has been listed as Example (D) above, Waksman HHJ commented that, first of all, "the terms of Condition 7 are entirely clear";[61] secondly, the insured argued that a concept of proportionality shall be introduced to the effect that if, as a matter of fact, the insurer had paid out most of the sum claimed, Condition 7 should not apply was clearly rejected by his Lordship, because there was no basis for introducing a proportionality requirement into it;[62] thirdly, the argument that insurer must show that it relied on the fraudulent statements was bound to fail because such further requirement could not be found in Condition 7.[63] Consequently, the learned judge held that if Condition 7 operated, the insurer would be in the same position as if he had avoided for material misrepresentation or non-disclosure at inception, so it was not liable to indemnity with regard to the latest claim and also could reclaim the money paid out on the previous two claims. His Lordship was of the opinion that whatever the common law position might have been was irrelevant since the insured had invoked an express

---

[58] *The Star Sea* [2001] 1 Lloyd's Rep.389, [51] (Lord Hobhouse)

[59] [1974] 1 Lloyd's Rep.147, 154

[60] [2010] EWHC 2192 (QBD). The facts of the case has been briefly summarized in Chapter Two, at [2.35]

[61] *Ibid.*,[88]

[62] *Ibid.*,[91]

[63] *Ibid.*,[93]

condition of the policy which made it unambiguous that the insurer may "avoid the policy from inception".[64]

(b) **Forfeited/Forfeiture**

[4.25] In Lloyd's J and J (A) Forms, the phrase "all claims are to be forfeited" is connected with the phrase "policy becomes void", pursuant to the interpretation given to "void" above, forfeiture in this context probably means all past claims in the relevant policy year are lost, and there is a respectable argument that settlements reached on claims prior to the fraud are liable to be undone.

[4.26] A more detailed analysis on "forfeiture" was conducted by Mance J in *Insurance Corp of the Channel Islands Ltd v McHugh*.[65] His Lordship was of the opinion that four possible consequences could be found in relation to the meaning of forfeiture:

(1) Forfeiture of the whole of the particular claim, leaving the policy otherwise untouched;

(2) Forfeiture of the benefit of the policy as from the date of the fraud;

(3) Forfeiture of the benefit of the policy as from the date when the claim arose;

(4) Forfeiture of the benefit of the policy *ab initio* so that any benefit already obtained or accrued is repayable or lost.

In that case, according to the words of the clause in question, which has already been cited as Example (B) above, Mance J made two observations: (1)the forfeiture was to extend to all benefit, even though only part of the claim may be fraudulent and whether or not the fraudulent means or devices relate to the whole or any part of any benefit otherwise claimable; and (2) it was all benefit under the policy which was to be forfeit, although the fraud related to a particular claim. Moreover, his Lordship was of the opinion that forfeiture of all the benefit under the policy would on its face embrace, at the least, loss of cover in respect of any future peril, which potentially means the policy was discharged prospectively. However, he also admitted that, alternatively, it was possible that the wording of the clause was effective to forfeit all

---

[64] *Ibid.*,[96]

[65] [1997] LRLR 94

benefit under the whole policy *ab initio*. His Lordship did not determine this point but he seemed to prefer to give a basically prospective construction so as to exclude entirely retrospective effect.

[4.27] It seems clear at this stage that if the clauses provide for forfeiture of the fraudulent claim, such as the insured "forfeits all benefit under the policy", or "forfeits all claim upon the policy", it indicates that the insured losses all benefits for the particular loss in respect of which he has made the fraudulent claim including any non-fraudulent elements. This position is consistent with the common law rule of rejection of particular fraudulent claim in the absence of an express provision, which has already been discussed above.[66] However, it is less clear and certain what the effect of forfeiture would be on the policy. In *Lehmbackers Earth Moving and Excavators v. Incorporated General Insurance*,[67] the Supreme Court of South African, by analogy of condition subsequent, held that the words "all benefit under this policy shall be forfeited upon the making of a fraudulent claim . . ." were at least clearly capable of bearing the meaning that as from the time that the fraudulent claim was made the insured should have no further benefit or claim under the policy; and therefore that valid claims already accrued (and a fortiori valid claims already paid out by the insured), remained inviolate and untouched by the subsequent unrelated fraudulent claim. But in *The Litsion Pride*,[68] Hirst J refused to adopt this approach. The correct position is still a moot point.

[4.28] Given that the words "forfeiture" might be the case of ambiguity, it is possible to argue that it should be construed "*contra proferentem*". In *Youell v Bland Welch & Co Ltd*, Staughton LJ commented accordingly on the *contra proferentem* principle: [69]

---

[66] *Axa General Insurance Ltd v Gottlieb* [2005] Lloyd's Rep IR.369

[67] (1984) 3 SA 513 AD

[68] [1985] 2 Lloyd's Rep.437, 515

[69] [1992] 2 Lloyd's Rep 127, 134

> "There are two well established rules of construction, although one is perhaps more often relied on with success than the other. The first is that, in case of doubt, wording in a contract is to be construed against a party who seeks to rely on it in order to diminish or exclude his basic obligation, or any common law duty which arises apart from contract. The second is that, again in case of doubt, wording is to be construed against the party who proposed it for inclusion in the contract: it was up to him to make it clear."

Firstly, the principle only applies where the meaning of words is ambiguous and the Court is unable to decide which of the meanings is appropriate in the context. Secondly, "insurance policies are traditionally drafted by the companies which issue them, and for that reason have often been strictly construed in favour of the insured. Indeed it has been said that the *contra proferentem* Rule strongly applies to such contract".[70] Thus, given that (i) words are ambiguity (ii) the harsh consequence of retrospective avoidance and (iii) the insurer may benefit from the clause, the clause may be construed *contra proferentem*, "forfeiture" may be interpreted narrowly, thus the insurer may not be exempted from all the liabilities under the policy; even if the insurer may be entitled to discharge from all the liabilities under the policy, this will not be a retrospective discharge but a prospective one. In any event, making the consequence of submitting the fraudulent claims clear instead of using the word "forfeiture" when drafting the clause might be the best solution in this regard.

(c) Condition precedent

[4.29] The examples involving the word "forfeiture" are most historical ones despite they are still embedded in the contemporary policies. However, as the law relating to fraudulent claims developed rapidly in the recent decade, it may be necessary to consider a well drafted fraudulent claims clause in the modern context. Clause 45.3 of International Hull Clause (01/11/03) duly arrived and can be regarded as a response of

[70] McMeel, G, *The Construction of Contracts-Interpretation, Implication and Rectification*, Oxford(2007), 6.27

the insurance market to the judgements recently delivered in respect of fraudulent claims. It deserves carefully considerations.[71]

[4.30] Clause 45.3 of International Hull Clause (01/11/03) provides as follows:

45.3 It shall be a condition precedent to the liability of the Underwriters that the Assured shall not at any stage prior to the commencement of legal proceedings knowingly or recklessly

45.3.1 Mislead or attempt to mislead the Underwriters in the proper consideration of a claim or the settlement thereof by relying on any evidence which is false

45.3.2 Conceal any circumstance or matter from the Underwriters material to the proper consideration of a claim or a defence to such a claim.

Two questions may be raised in relation to the interpretation exact meaning of this particular clause: (i) the effect of breach and (ii) the ambit of application.

(i) The effect of breach: the meaning of "condition precedent"

[4.31] In insurance context a condition precedent usually takes one of the two forms[72]

(A) Condition precedent to the attachment of the contract or risk, where there will be no contract at all or the rights and obligations arising out of the contract will not be operated if the condition precedent is not fulfilled.

---

[71] International Hull Clauses 2002 has already contained a similar fraudulent claims clause, which is Clause 48.3, but this clause, as will be pointed out, is not well-drafted. So the attention will not be focused on International Hull Clauses 2002. See Skajaa, L, *International Hull Clauses 2002: a contractual solution to the uncertainty of the fraudulent claims rule?* [2003] LMCLQ 279. See also Skajaa, L, *Fraudulent devices-the market response (International Hull Clauses 2003)* [2004] LMCLQ 139

[72] See Soyer, B, *Classification of terms in marine insurance contracts in the context of contemporary developments*, Chapter 5 of *Marine Insurance: Law in Transition*, Thomas, DR, (Ed), LLP (2002), 5.11

(B) Condition precedent to the insurer's liability under the policy, where the insurer will not be liable in respect of the loss in question if the condition precedent is not fulfilled.

[4.32] It is observed by Colman J in *Alfred McAlpine v BAI (Run-Off) Ltd*:[73]

> "It is now generally the practice to insert a term which provides that the due observance and fulfillment by the assured of all the terms, provisions, conditions and endorsements of the policy in so far as they relate to anything to be done or complied with by the assured is to be condition precedent to any liability of the insurer to make payment under the policy"

From the wording of clause, it can be concluded that this is a condition precedent to the liability of the underwriters, non-compliance of which, depending upon the proper interpretation of the words, will entitle the insurer to reject a particular claim with the policy remaining intact for prospective claims

[4.33] Several arguments could be put forward to support this contention. First of all, the clause at least makes it clear the there should be no scope of the application of retrospective avoidance as the remedy.[74] Secondly, it is probably obvious to say that the typical consequence of non-compliance would be the rejection of the whole particular claim even if the claim is genuine and recoverable in part but fraudulent otherwise.[75] Thirdly, as the clause stipulates that "it shall be a condition precedent to *the liability of the Underwriters*" instead of "a condition precedent to *the liability for the claim of the Underwriters*", it is arguable that the consequences of breach may extend beyond the particular claim in question to future claims, which means the underwriters may be entitled to discharge from all the liabilities prospectively under the policy. The insured may argue that individual claims constitute severable obligations so that the use of fraudulent evidence may affect only the particular claim

---

[73] [1998] 2 Lloyd's Rep.694, 701

[74] Longmore, *Good faith and breach of warranty: are we moving forwards or backwards* [2004] LMCLQ 158, 170.

[75] *Axa General Insurance Ltd v Gottlieb* [2005] Lloyd's Rep IR.369

in question,[76] but following the decision of Court of Appeal in *Friends Provident Life & Pensions Ltd v. Sirius International Insurance*,[77] this so-called severability approach or partial repudiation approach might have already be dead.[78] In addition, in contrast with Clause 45.1 and 45.2 of International Hull Clause 2003 which are basically ancillary provisions, Clause 45.3 stipulates the main obligations of insured in the process of submitting a claim and therefore goes to the root of contract. Consequently, there is nothing in principle preventing the underwriters to escape from liabilities prospectively if the clause is breached. Furthermore, by analogy with the legal effect of breach of warranty, it is submitted that the breach of Clause 45.3 does not have the effect to bring the contract to the end, only the liabilities of the underwriters are terminated[79] and accordingly, on the one hand, it is possible that there may be obligations of the insured under the contract which will survive the discharge of the insurer from liabilities, for example, a continuing liability to pay a premium;[80] on the other hand, the continued existence of the policy may be of importance to the insured in other situations such as compliance with insurance covenants in loan and security documents.

(ii) The ambit of application: does this clause change the position of common law?[81]

[4.34] Clause 45.3 is more wide-ranging in its approach to fraudulent claims and deserves more intensive examination.

---

[76] *Alfred McAlpine v BAI (Run-Off) Ltd* [2000] 1 Lloyd's Rep.437 (CA)

[77] [2005] 2 Lloyd's Rep.517

[78] In this case, Mance LJ, not following the case of *Alfred McAlpine*, was of the opinion that a sufficiently serious breach of an innominate term could only lead to the discharge of the whole insurance contract, not just the particular claim. There should be no such doctrine called partial repudiatory breach. See Soyer, B, *Classification of terms in marine insurance contracts in the context of contemporary developments*, Chapter 5 of *Marine Insurance: Law in Transition*, Thomas, DR(Ed), LLP(2002), 5.46-5.47.

[79] *The Good Luck* [1991] 2 Lloyd's Rep.191, 202(Lord Goff)

[80] *Ibid.*, 201

[81] See Skajaa, L, *International Hull Clauses 2002: a contractual solution to the uncertainty of the fraudulent claims rule?* [2003] LMCLQ 279

- Clause 45.3.1-Mislead or attempt to mislead

[4.35] Mance LJ made it clear in *Agapitos v Agnew*[82] that in the case of claim for a loss known to be non-existence or exaggerated, as long as the claim is deemed fraudulent it is not significant that whether underwriters are misled or not. The wording of Clause 45.3.1 clearly reflects this view: there is no requirement for an underwriter to show that he was actually induced by false evidence if he wants to reject the claim on the basis of Clause 45.3.1.

- Clause 45.3.1-Proper consideration of a claim

[4.36] The phrase "proper consideration of claim" is crucial to clearly understand the meaning of not only Clause 45.3.1 but also Clause 45.3.2 in the sense that not every knowingly or recklessly false statement made in the submission of the claim would bring the clause into play.[83] It is submitted that the test set out by Mance LJ in *Agapitos v Agnew*[84] in relation to the use of fraudulent means and devices would be the proper one comprising appropriate elements of objectivity and subjectivity to assist the interpretation of this phrase. First of all, it should be considered whether the false evidence is directly related to the claim. For instance, a purportedly backdated letter adduced by insured in order to deceive the underwriters after the ship sailed into the restricted held cover area without paying additional premium was considered as a fraud directly connected to the claim.[85] Secondly, it should also be taken into account that whether or not the false evidence presented, if believed, would tend to result in a not insignificant improvement in the insured's prospects of winning the claim. In *The Mercandian Continent*[86] the insured, purportedly to assist (not to deceive) his liability underwriter, was of the opinion that Trinidad jurisdiction would be more favourable, which turned to be untrue because this was wrongly advised by the solicitors, and therefore challenged English jurisdiction agreement with a third party by a forged

[82] [2002] 2 Lloyd's Rep.42, 51

[83] *Royal Boskalis Westminster NV v Mountain* [1997] LRLR 523, 593(Rix J)

[84] [2002] 2 Lloyd's Rep.42, 53

[85] *The Litsion Pride* [1985] 1 Lloyd's Rep.437

[86] [2001] 2 Lloyd's Rep.563. The full facts and the analysis of the case will be introduced in details below at [4.93]

letter questioning the delegated authority of signing jurisdiction agreement. That fraud made no difference to the liability of the underwriters under the policy and the prospects of a successful claim was not improved as a result, thus the underwriter was not entitled to rely on the rules relating to fraudulent claims or even fraudulent means or devices in support of a claim.

- Clause 45.3.2-Material concealment

[4.37] It seems from the above analysis that Clause 45.3.1 does not change the position of common law to a large extent. However, Clause 45.3.2 may go further in the sense that this provision clearly requires the insured to make full disclosure of material circumstances or matters in relation to claims. It should be noted in the first place that in the version of International Hull Clause 2002, a slightly different draft can be found in the clause 48.3 which reads as concealment of "any circumstance or matter from the Underwriters which *might be material* to the proper consideration of a claim or defence to such claim." It is submitted that the added words "which might be material" seems to be confusing, which will introduce the uncertainty and cast the doubt whether these words deliver an intention to ensure a greater degree of disclosure than would be achieved by applying the prudent insurer test of materiality.[87] Nevertheless, even if those words have been taken out of the International Hull Clause 2003, the meaning of materiality still needs to be determined. Currently, there may be two tests available: the first is the one adopted by Hirst J in *The Litsion Pride*,[88] where it was held that a material circumstance or matter would be one which, if disclosed, would influence the decision of a prudent underwriter to accept, reject or compromise the claim; the second is the one laid down

[87] Skajaa, L, *International Hull Clauses 2002: a contractual solution to the uncertainty of the fraudulent claims rule?* [2003] LMCLQ 279, 285; See also Skajaa, L, *Fraudulent devices-the market response (International Hull Clauses 2003)* [2004] LMCLQ 139

[88] [1985] 1 Lloyd's Rep.437, 513. It is submitted that this part of the decision is not affected by the disapproval in *The Star Sea* [2001] 1 Lloyd's Rep.389 of the finding that fraudulent claim formed part of the duty of utmost good faith. See Merkin, R, (Ed), *Colinvaux & Merkin Law of Insurance Contracts* (loose-leaf), Sweet&Maxwell, para. 30376.

by Longmore LJ in *The Mercandian Continent*,[89] where it was held that the fraud must be material in the sense that the fraud would have an effect on underwriters' ultimate liability. It is suggested that the latter test is inappropriate in the context of Clause 45.3.2 mainly because, as it will be demonstrated below, the test would not work at all in the case of use of fraudulent devices and means, [90] but Clause 45.3 is actually designed as a market response to this rapidly developed type of fraudulent claims. The former test, as it is submitted,[91] is consistent with the judicial interpretation of the insured's statutory duty of disclosure at pre-contractual stage interpreted in the case of *Pan Atlantic v Pine Top*.[92] Working together with the test set out in *Agapitos v Agnew* for the purpose of deciding the meaning of "proper consideration", it would produce a balanced approach to the determination of the contents of disclosure.

(iii) Conclusions

[4.38] Given the uncertain state of law on fraudulent claims, it is warmly welcomed that the market took the opportunity to offer an express clause regulating this matter. However, the wording is not sufficiently enough and uncertainties remain, e.g. whether the consequences of breach is only the resistance of the particular claim or the underwriter could choose either to reject the claim in question or to discharge from all the liabilities prospectively. Perhaps this misunderstanding can be avoided if in the subsequent edition of the International Hull Clause, the draftsmen prefer to specify the consequence of the breach.

[89] [2001] 2 Lloyd's Rep.563, [35]

[90] See below, at [4.93] and [4.116]

[91] Skajaa, L, *International Hull Clauses 2002: a contractual solution to the uncertainty of the fraudulent claims rule?* [2003] LMCLQ 279, 285

[92] [1995] 1 AC 501

(d) Warranty

[4.39] Although it seems extremely rare[93] to find a fraudulent claims clause to be expressed as a warranty in the policy, such as "it is warranted that the assured will not submit fraudulent claim", there is no solid principle preventing the insurers to create such a warranty in the policy because the breach of warranty defence is one of the most effective and powerful defence for an underwriter. The consequence of breach of warranty is serious: according to Section 33 (3) of the Marine Insurance Act 1906, "the insurer is discharged from liability as from the date of the breach of warranty, but without prejudice to any liability incurred by him before that date", and it was clarified in *The Good Luck*[94] that this means breach automatically discharges the insurer from liability from the date of breach. The implications of the automatic discharge rule would be:[95] (i) any liability on the insurer which had accrued before the date of breach, such as unpaid clean claims, remains unaffected; (ii) in cases where a fraudulent claim is followed by a clean claim, the insurer will be justified in his refusal as to both claims.

[4.40] However, there are certain rules which should be followed in order to effect such creation. First of all, the terms should satisfy the description of Section 33 (1) of the Marine Insurance Act 1906 which provides that "the assured undertakes that something particular thing shall or shall not be done, or that some condition shall be fulfilled, or whereby he affirms or negatives the existence of a particular state of facts". Secondly, Section 35 (1) of the Marine Insurance Act 1906 clearly provides that "an express warranty may be in any form of words from which the intention to warrant is to be inferred", which means no formal or technical wording is required for the creation of an express warranty. Thus, on the one hand, the words "warranty" or "warranted" are not essential in order to create an express warranty. For instance, in *Aktielskabet Greenland v Janson*,[96] a clause expressed "No mining timber carried"

---

[93] It seems that currently no practical example can be found in this respect, thus the following discussions will be purely based upon legal theories.

[94] [1991] 2 Lloyd's Rep.191

[95] See Soyer, B, *Warranties in Marine Insurance*, 2nd edn, Cavendish Publishing (2005), 149-151

[96] (1918) 35 TLR 135

was held to be an express warranty; On the other hand, the words "warranty" or "warranted" would just create a strong indication that the parties mean what they say, but not be clear enough to create a warranty in the context of Section 33 of Marine Insurance Act 1906. For example, in a Canadian case *The Bamcell II*,[97]a clause in the policy providing that "warranted that a watchman is stationed on board *The Bamcell II* each night from 2200 hours to 0600 hours with instructions for shutting down all equipment in an emergency" was held to be a suspensory provision and not a warranty. Thirdly, in the judgement of the Court of Appeal in *HIH Casualty & General Insurance Ltd v New Hampshire Insurance Co and others*,[98] Rix LJ proposed three tests shall be satisfied in order to create a warranty: the term (a) goes to the root of the contract; (b) it is descriptive of the risk or bears materially on the risk of loss; and (c) damages would be an inadequate or unsatisfactory remedy for breach.[99]

[4.41] It seems that the first test could be satisfied as well as the third test as the fraud may seriously jeopardize the interests of the insurer to do business with the fraudsters in the future with the result that insurers want to be discharged from the relationship instead of only being awarded damages. However, the second test is unlikely to be fulfilled because it is difficult to categorize the presentation of fraudulent claim as a description of the risk or bearing materially on the risk of loss. It is submitted that warranties are used to determine the scope of the cover agreed by the insurer and it plays an essential role in assessing the risk,[100] but a statement requiring not to presentation of fraudulent claims barely shares this function of warranties, for instance, in the case of fraudulent devices in support of an otherwise genuine claim, the loss is indeed a result of the insured risk and covered by the policy. Thus, it may not possible for the insurers to get the benefit of breach of warranty from a clause stating "warranted not to submit fraudulent claims" or similar wordings. This kind of "warranty" clause, if existed in the practice, may just borrow its most traditional non-

[97] (1980) 133 DLR (3d) 727; [1983] 2 SCR 47

[98] [2001] 2 Lloyd's Rep.161

[99] *Ibid.*, [101]. See Soyer, B, *Warranties in Marine Insurance*, 2nd edn, Cavendish Publishing (2005), 11-16

[100] Soyer, B, *Warranties in Marine Insurance*, 2nd edn, Cavendish Publishing (2005), 2-3

insurance sense and be treated as a term of contract the breach of which entitles the innocent party to damages only but not a right to treat the contract as repudiated.[101]

C. Conclusions

[4.42] The draftsman of the Marine Insurance Act 1906, Sir Mackenzie Chalmers said that: [102]

> "A man of business, in effect, says to the lawyers, 'leave me free to make my own contracts, but tell me plainly beforehand what you are going to do if I don't make a contract, or if I fail to express it intelligibly. If I know beforehand exactly what you lawyers are going to do in a given case, I can regulate my conduct accordingly. All I want to know is exactly where I am."

Those words demonstrate the significance of certainty in commercial law and deserve clearer executions in legislations, case laws and standard clauses.

[4.43] Thus, dealing with fraudulent claims by express provisions in the policy can certainly bring certainty to the relationships between insured and insurer and will be hailed by both parties. Nevertheless, the situation would be better if (1) the historical phrase such as "forfeits all benefits/all claims under/upon the policy" could be re-considered and construed in the modern context or even not to be employed in the modern policies; (2) clear words such as termination, cancellation or avoidance are to be written in the policy; and (3) the consequences of breach and other relevant elements are to be drafted in the clearest possible terms in order to be free from ambiguities.[103]

---

[101] Nevertheless, a clear wording would avoid all these difficulties, e.g. if the consequence of the breach is explicitly agreed as being automatically discharge.

[102] Chalmers, *Codification of Mercantile Law* (1903) 19 LQR 10, 14

[103] A thoroughly drafted clause could be provided as follows (This Clause is published by Aviation Insurance Clauses Group at http://www.aicg.co.uk/. Reference number is AVN 100 26.7.08):

"An Insured shall not in the presentation and furtherance of any claim:

III. The Implied Contractual Approach

[4.44] The content of a contract consists in its terms containing express terms as well as implied terms. At the first sight, it is theoretically odd for the common law jurisdiction to allow the implication of terms because it conflicts with the basic ideas about the contract law, namely meeting of minds and freedom of contract.[104] Nevertheless, it is well-argued that implied terms are one of the common law's inbuilt mechanisms for achieving the same ends as good faith in the civil law.[105] In essence,

---

(a) deliberately or recklessly conceal from Insurers any information which he knows or ought to know might
be material to their consideration of any claim;
(b) provide to Insurers information, which he knows to be false, with respect either to any event relied upon as
a cause of loss or as to the amount claimed; nor
(c) otherwise use fraudulent means or devices, including suppressing a known defence to Insurers' liability.
In any such event the Insurers shall have the option to refuse to pay the whole or any part of the claim to such Insured.
In the circumstances set out in sub-paragraph (b) above, Insurers shall also have the option to:
(i) terminate the cover provided by all sections of the Policy to such Insured with effect from the date of the event relied upon for the claim;
(ii) recover any sums paid to such Insured in respect of losses occurring on or after the date of the event relied upon for the claim; and
(iii) retain any and all premium paid by such Insured.
If any provision of this clause is in conflict with the law governing the Policy it shall be of no effect to the extent of such conflict."
Another clause in similar wording could be found at Henley, C, *Drafting Insurance Contracts, Leadenhall Press* (2010), 3.88.3

[104] See Richard Austen-Baker, *Implied terms in English Contract Law*, Edward Elgar (2011), 1.03-1.05

[105] See Peden, *Policy concerns in terms implied in law* (2001) 117 LQR 459; Carter & Peden, *Good faith in Australian Contract Law* (2003) 19 JCL 155. It shall be noted that Lord Denning 's attempt to introduce a requirement that the terms of the contract shall meet with broad notions of fairness was firmly rejected by the House of Lords. See *Liverpool City Council v Irwin* [1977] AC 239, 254(Lord Cross),258(Lord Wilberforce)

the implication of terms represents the need that something shall be supplied by the law to ensure substantial fairness and the fulfilment of contractual expectations, thus helping to hold contracts intact [106] Therefore, an understanding of implied terms is absolutely indispensable to an understanding of the contents of contract.

[4.45] Since the primary relationship between insured and insurer is indeed contractual, then the further question arises that in the absence of express provisions, can the terms handling fraudulent claims be implied into the contract? It shall be borne in mind that the door for implication of a term into contract is difficult to open, as Lord Bingham observed that: "it is because the implication of terms is so potentially intrusive that the law imposes strict constraints on the exercise of this extraordinary power".[107]Once it has been established that it is indeed an implied term of the contract, the question arises as to its comparative importance and effect. In other words, what is the characterization of this term and what are the remedies for breach?

A. The basis for implying a term requiring insured not to submit fraudulent claims

(a) Implication in fact or Implication by law?

[4.46] Classical textbooks categorize the implied terms into four groups: terms implied by statute, terms implied by trade usage and custom, terms implied in fact and terms implied in law. For the purpose of current discussion, only the last two types are relevant, and the difference between those two was firstly established by Lord Wright in *Luxor (Eastbourne) Ltd v Cooper*[108] that:

---

[106] Austen-Baker, R, *Comprehensive Contract Theory: a Four-Norm Model of Contract Relations* (2009) 25 JCL 216; See also Austen-Baker, R, *Implied terms in English Contract Law*, Edward Elgar (2011), 2.16-2.24

[107] *Philips Electronique Grand Publique SA v British Sky Broadcasting Ltd* [1995] EMLR 472, 481

[108] [1941] AC 108, 137

"The expression 'implied term' is used in different senses. Sometimes it denotes some term which does not depend on the actual intention of the parties but on a rule of law, such as terms, warranties or conditions which, if not expressly excluded, the law imports, as for instance under the Sales of Goods Act and the Marine Insurance Act. But a case like the present is different because what it is sought to imply is based on an intention imputed to the parties from their actual circumstances."

[4.47] Lord Wright's dichotomous approach had gradually attracted attention in the following cases. In the leading case *Liverpool City Council v Irwin*[109] the differences between two kinds of implied terms were fully developed. Lord Cross classically stated that:

"When it implies a term in a contract the court is sometimes laying down a general rule that in all contracts of a certain type - sale of goods, master and servant, landlord and tenant and so on - some provision is to be implied unless the parties have expressly excluded it. In deciding whether or not to lay down such a prima facie rule the court will naturally ask itself whether in the general run of such cases the term in question would be one which it would be reasonable to insert. Sometimes, however, there is no question of laying down any prima facie rule applicable to all cases of a defined type but what the court is being in effect asked to do is to rectify a particular - often a very detailed - contract by inserting in it a term which the parties have not expressed. Here it is not enough for the court to say that the suggested term is a reasonable one the presence of which would make the contract a better or fairer one; it must be able to say that the insertion of the term is necessary to give - as it is put -'business efficacy' to the contract and that if its absence had been pointed out at the time both parties - assuming them to have been reasonable men - would have agreed without hesitation to its insertion."

[109] [1977] AC 239, 257-258. In this case, the council let flats in a tower block to tenants but the latter then withheld the rent as a protest at conditions in the building. The agreement was silent regarding the obligations of the council to maintain the common place in the building and the tenants claimed that council had breached its implied duty to keep the block in proper conditions. The Houses of Lords held that as a necessary incident of all tenancy agreements in which the tenants were entitled to use the common place of the building such as stairways, lifts, etc., an obligation shall be implied on the council to take reasonable care to keep in reasonable repair and usability of the common parts of the tower block.

[4.48] The differences between terms implied in fact and terms implied in law could be drawn from the above speeches: On the one hand, terms are implied in fact in order (i) to try to arrive at the parties' actual intention on matters which they omitted to express in the contract or (ii) to find the presumed intention of the parties, over matters about which they may not have thought at the time of contracting. Terms implied in fact are designed to supplement the unexpressed but supposed actual intentions of the parties in a contract which are likely to be personal to them. They usually concern a term not commonly found in contract in general. In short, terms implied in fact only involve the particular contract, the exact transaction, under consideration by the court. Whether or not a term shall be implied depends upon the intention of the parties gleaned from the express terms of the agreement and the factual matrix of the case in question.[110] On the other hand, in many classes of contract, however, implied terms have become standardized, and it is somewhat artificial to attribute such terms to the unexpressed intention of the parties. The court is, in fact, laying down a general rule of law that in all contracts of a defined type, for example, sale of goods, the carriage of goods by sea and employment contract, certain terms will be implied, unless the implication of such term would be contrary to the express words of the agreement. Such implications do not depend on the intentions of the parties, actual or presumed, but on more general considerations. Lord Denning described the process of implication of terms in law as occurring in all common contractual relationship:[111]

> "In such relationships the problem is not solved by asking: what did the parties intend? Or, would they have unhesitatingly agreed to it, if asked? It is to be solved by asking: has the law already defined the obligation or the extent of it? If so, let it be followed. If not, look to see what would be reasonable in the general run of such cases...and then say what the obligation shall be."

Accordingly, the basis for the implication of terms in this way appears to be the policy reasons essentially, namely, the desire to regulate certain common types of contract. It is done so that one party does not take unfair advantage of another, and so that adequate protection is given to both parties.

---

[110] *Associated Japanese Bank (International) v Credit du Nord SA* [1989] 1 WLR 255, 263

[111] *Shell UK Ltd v Lostock Garage Ltd* [1976] 1 WLR 1187, 1196

[4.49] In conclusion, the difference between terms implied in fact and terms implied in law may be summarized as follows: implication in fact operates as "*ad hoc* gap fillers",[112] targeting on the particular contract in question whereas implication by law works as general default rules, focusing on the particular types of contract in general. However, on the other hand, the boundaries between two types of implications may not absolutely be clear, in the sense that a term may start as ad *hoc* gap fillers but may be later admitted as a general default rule for common relationships between particular groups of parties.

[4.50] Applying the test into the context of insurance contract, in the absence of express terms, does insurance contract require general default rules handling fraudulent claims, or does every case need to be solved on its own factual background? It is submitted that in the perception of the insurance industry, insurance fraud of various kinds have been found in the motor, household, commercial contents and fire sectors, and has become commonplace.[113] On the one hand, insurance fraud has become a subject of intensive studies and insurers tend to approach the claims with great cautions; on the other hand, due to the insufficient and ambiguous legal framework, the insureds may not have a clear mind regarding their legal positions as to the commitment of fraudulent claims. A judicial announcement may therefore be needed and a general default rule adjusting the relationships between parties in this regard may also need to be known to the public. The underlying concern is based upon the policy reasons of regulating all the insurance contracts rather than the construction of the particular contract. Accordingly, it may be better to imply the term requiring insured not to submit fraudulent claims in law rather than in fact. In addition, it shall be borne in mind that the finding of such a term in one case may bind in subsequent cases as a matter of precedent but this position would not be conceivable or persuasive in the case of terms implied in fact because it is on an on-off basis.

---

[112] *Equitable Life Assurance Society v Hyman* [2002] 1 AC 408, 459 (Lord Steyn)

[113] Clarke, M, *Policies and Perceptions of Insurance Law in the Twenty-First Century*, Oxford (2005), 200-201. See the Introduction of the thesis

(b) The policy concerns supporting the implication

[4.51] Since It has been suggested that a term requiring the insured not to submit the fraudulent claims shall be implied in law, the next question arises as to the policy concerns supporting the implication. In other words, what is the test for such implication? In the leading case on terms implied in law *Liverpool City Council v Irwin*,[114] Lord Wilberforce suggested that the test was one of necessity, and in a following case *Scally v Southern Health and Social Services Board*, [115] Lord Bridge was seemingly going a bit further and suggesting that the search for a term which the law would imply as a necessary incident of a definable category of contractual relationship was based on a wider considerations. It will be demonstrated below that how the route has been altered from strict necessity test to wider considerations and in practice what these wider considerations might include and how to apply them in the context of insurance claims.

(i) Necessity

[4.52] It is usually suggested that the legal test for the implication of a term is the standard of "strict necessity".[116] However, the rigid strictness test seems to be relieved

[114] [1977] AC 239

[115] [1992] 1 AC 294, 307. In this case, the House of Lords, identifying the contract in question as employment contract, implied a term obliging the employer to take reasonable steps to inform his employees regarding the changes to their pension scheme where the employees could not be expected to be aware of the term. However, their Lordships went further to suggest that this contract was within a specific subcategory and accordingly did not apply to all contracts of employment. It was criticized that this judgement may blur the lines between the implication in fact and implication in law, but first of all, it seems the problem would not exist in the case of insurance contract which needs the regulations dealing with fraudulent claims in all types and secondly, it has been argued that a defined type of contract could be determined by referring to the existence of trades or professional arrangements. For example, it may be argued that in the case of *Scally*, the relationship might be considered as the employment relationships between employees and Government health authorities. See Peden, *Policy concerns in terms implied in law* (2001) 117 LQR 459, 463-465

[116] *Liverpool City Council v Irwin* [1977] AC 239, 266 (Lord Edmund-Davies) "touchstone is always necessity and not merely reasonableness"

in the views of recent development of law. Professor Atiyah suggested that "reasonable necessity" should be enough to imply a term:[117]

> "The formula that implications can only be made when necessary is not to be taken too literally. It is not necessary to have lifts in blocks of flats ten stories high (indeed high rise building existed long before lifts were invented), though it would no doubt be exceedingly inconvenient not to have them. So 'necessary' really seems to mean 'reasonably necessary', and that must mean, 'reasonably necessary having regard to the context and the price'. So in the end there does not seem to be much difference between what is necessary and what is reasonable."

Similarly, Professor Gerard McMeel proposed that:[118]

> "At bottom the implication of terms in law is a matter of public policy, and despite occasional judicial statements suggesting that the test is one of necessity in practice broader standards of reasonableness and an analysis of competing factors will determine whether or not the courts will recognize a new implied term in law."

[4.53] In the Court of Appeal's decision in *Crossley v Faithful&Gould Holdings Ltd*,[119] the issue before the court was whether or not there was an implied term of any contract of employment that the employer will take reasonable care for the economic well-being of his employee. The Court of Appeal was of the opinion that it would be "unreasonable" to require the employer "to have regard to the employee's financial circumstances when he takes lawful business decisions which may affect the employee's economic welfare." The function of the employer was not to "act as his employee's financial adviser." The court rejected the proposed implied terms not on the need for such a term, but on the appropriateness of the term having regard to the court's perception of the nature of the relationship that exists between an employer and an employee. So it appears that the test applied by the courts in cases of terms

[117] Atiyah, *An Introduction to the Law of Contract*, 5th edn, Oxford (1995), 207

[118] McMeel, G, *The Construction of Contracts: Interpretation, Implication and Rectification*, Oxford(2007), 10.03

[119] [2004] 4 ALL ER 447

implied in law may no longer be based solely on necessity, but on a combined consideration of necessity, reasonableness, business efficacy and appropriateness.[120]

(ii) Combination of policy concerns

[4.54] Reasonableness and fairness are always the cardinal underlying notion for the purpose of implying a term into contract. Implication requires a consideration of all the issues and a balancing exercise of courts as to the competing interests. The following non-exhaustive concerns could be relevant.

- **Parties' bargaining positions**[121]

[4.55] The insured always knows more about what happened to subject-matter insured than insurer so it fairly assumes that he is in a better position when he puts the claim on the table. The parties' bargaining position is an underlying concern when the courts grant the implications. The courts are more likely to impose an obligation on the party in the stronger position in order to protect the weaker party, and in the context of insurance contract, it is reasonable to say that a term could be implied in order to prevent the insured using his better position in terms of knowledge surrounding the loss to defraud the insurer.

- **Remedies as to the validity of policy**

[4.56] It is submitted that the courts are more likely to imply a term if it will provide the only way in which an innocent party will have a remedy or if another remedy would be extremely difficult to invoke.[122] It has already been demonstrated that in the absence of express terms, a fraudulent claim might be rejected but the insurance contract remains stand. In addition, it is also difficult for the insurers to invoke the

---

[120] Peden, *Policy concerns in terms implied in law* (2001) 117 LQR 459

[121] *Ibid.*, 472

[122] *Ibid.*, 473. *Scally v Southern Health and Social Services Board* [1992] 1 AC 294

remedies of avoidance in the current judicial environment.[123] Fraud may make the insurer never want to do business with the fraudulent insured, but the current position is if there is no functional express term, insurer has no other remedies if he wants to discharge from the insurance contract. Thus, the courts could be influenced to imply a term in such situations.

- **Consistency with general principles**[124]

[4.57] It is a standard term in various insurance policies that, if any claim is made which is fraudulent, certain consequences will be triggered, so it makes sense that in absence of such express terms, a term with similar function will be implied. In addition, the court will support the implication of terms in accordance with the values which are significant to the legal system. Of primary focus in relation to insurance law would be the notion of good faith, so the court might also support the implication of terms against the fraud and bad faith in general.[125]

- **Effect on society**[126]

[4.58] Courts sometimes expressly consider the effect of implying a term having on society and are willing to deter undesirable behavior. It has been emphasized repeatedly that how negative the impact of fraud can be on the society and there is no obvious reason why the courts will be reluctant to decline an implication of deterring and punishing fraud, as a claim handler said that:[127]

> "Within the insurance market we have to respond speedily and with empathy to policyholders and that is only right. However, it is also imperative that we validate

[123] See below, particularly at [4.114] and [4.115]

[124] *Ibid.*, 474

[125] It should be noted that good faith itself cannot be implied into the contract as a term. See below, at [4.149]-[4.151]

[126] *Ibid.*

[127] *Fraud Investigation, A Claim Handler's Guide*, available at http://www.cila.co.uk, accessed on 4th April 2012

claims properly to ensure that the premium pool which is funded by all policyholders is not depleted by the fraudulent activities of a few."

(c) The conflict between implied terms and express terms

[4.59] Since a term requiring insured not to submit fraudulent claims is implied by law, as it is submitted, which means every insurance contract shall contain such a term, situation may arise that the parties agree an express fraudulent clause in the contract and the application of express fraudulent clause may bring different result. This conflict could be solved by the well-established principle that the express terms represent the totality of the parties' willingness to agree and their actual intention regarding the contents of the contract and accordingly, an implied term must "always yield to the express letter of the bargain"[128].

[4.60] In addition, in *Photo Production Ltd v Securicor Transport Ltd*,[129] on the one hand, Lord Diplock emphasized the importance of implication by law in commercial contract; on the other hand, his Lordship also recognized that the parties have freedom to agree the express terms that surpass the implications. He said:

> "A basic principle of the common law of contract, to which there are no exceptions that are relevant in the instant case, is that parties to a contract are free to determine for themselves what primary obligations they will accept. They may state these in express words in the contract itself and, where they do, the statement is determinative; but in practice a commercial contract never states all the primary obligations of the parties in full; many are left to be incorporated by implication of law from the legal nature of the contract into which the parties are entering. But if the parties wish to reject or modify primary obligations which would otherwise be so incorporated, they are fully at liberty to do so by express words."

[128] *Lynch v Thorne* [1956] 1 WLR 303, 306 (Lord Evershed MR)

[129] [1980] AC 827, 850

[4.61] However, as it has been discussed at some length in Chapter One[130] and Chapter Two,[131] a limitation should be put here: it seems clear that an express term allowing the commitment of fraud would be hopeless in the light of public policy considerations, so there would no conflict in this regard. However, if the fraudulent claim is presented by insured's agent without the knowledge of the principal, a clear and unmistakable term on the face of the contract so as to leave the other party in no doubt that fraud of the agent is excluded may protect the insured in the relevant cases.

[4.62] Accordingly, a more accurate conclusion regarding the relationship between the implied terms and express terms is: terms implied in law may be overruled by the inconsistent express terms, but ultimately it depends upon a proper interpretation of the extent of the express terms. [132]

B. The characteristic of the implied term not to submit fraudulent claims

(a) The impact of fraud on the validity of the contract from the perspective of general contract law

[4.63] It is noteworthy that liability for breach of contract is strict in principle and is not generally dependent upon a finding that the party in breach has been at fault, that is to say, bad faith is not an essential element of breach of contract. A breach is a breach whether it is committed in good faith or bad faith. Nevertheless, in certain circumstance courts may take the good faith of the party in breach into account when deciding whether or not the breach of contract was a repudiatory breach which entitles the other party to terminate the contract.

---

[130] Chapter One, at [1.22]

[131] Chapter Two, at [2.7]

[132] *Johnstone v Bloomsbury Area Health Authority* [1991] 2 WLR 1362. In this case, it was held that employer's implied duty not to endanger employee's health and safety cannot be overridden by a contractual term allowing the employer to require the employee to work a given number of hours or in a given place.

[4.64] In *Vaswani v Italian Motors (Sales and Services),*[133]the sellers agreed to sell a car to the buyer for a specified price, which was the same as that shown in their price list for that type of car, and the buyer paid a deposit. A clause printed in the contract in red provided that the price could be adjusted by the sellers in certain circumstances and then the price ruling at the date of delivery would prevail. Conditions 4 and 5 permitted the sellers to adjust the price if their costs had been increased as a result of certain matters. Condition 8 entitled the sellers to forfeit the deposit if after having been notified by the sellers of their readiness to deliver the car the buyer failed to pay for it within seven days. When the car was ready for delivery the sellers requested the buyer to pay the balance of the purchase price, which the sellers calculated on the basis of the increased sale price in their price list at that date. The sellers eventually notified the buyer that unless completion took place on a particular day they would treat the contract as being terminated and forfeit the deposit, but no further payment was made by the buyer and so the sellers forfeited the deposit. The buyer sued for the return of his deposit. Two interrelated issues arose before the Privy Council. The first was whether or not the sellers were entitled to demand that the buyer pay the increase sum on the interpretation of contract as a whole. The second was, on the assumption that the sellers were not so entitled, whether they had repudiated the contract by demanding that the buyer pay a sum of money which he was not obliged to pay according to the terms of contract. Lord Woolf, in the first place, concluded that the sellers were not entitled to demand the buyer pay the increased sum. Furthermore, his Lordship ruled that the sellers had not repudiated the contract by requesting for the payment of an excessive price as the request was made in good faith but erroneous view as to the effect of the contract.

It may be concluded that the court was reluctant to hold that a party who acts in good faith has repudiated the contract,[134] but looking the question from a different

[133] [1996] 1 WLR 270

[134] It is submitted that the position is similar to the cases where it could be held that it is not repudiation for one party to put forward his genuine and bona fide interpretation of what the contract requires of him. But where that party performs in a manner which is not consistent with the terms of the contract, it is no defence for that party to show that he has acted in good faith. See McKendrick, E, *Contract Law: Text, Cases and Materials*, 3rd edn, Oxford (2008), 813.

perspective, it may also be concluded that the court will be willing to hold that a party who commits the breach in bad faith has repudiated the contract.

[4.65] In addition, when considering whether or not a breach of contract entitles the innocent party to terminate further performance of the contract, the nature of the terms breached shall be taken into consideration. A right to terminate will arise when the term broken is a condition but will not work where the term breached is just a warranty in the technical sense of the word. If the term broken is an intermediate term or innominate term, the answer to whether breach justifies termination will turn on the seriousness of the consequences of the breach. Provided that the breach is such as to deprive the innocent party substantially of the benefit that the intended to obtain from performance, the innocent party is then entitled to terminate the contract.[135] Suppose a case where an intermediate term is breached fraudulently by one party, the innocent party may have serious doubts as to the ability and sincerity of the guilty party to perform in the future and, therefore, there is a strong possibility that the innocent party is entitled to treat the fraudulent breach as repudiatory breach and terminate the contract accordingly. Essentially, being a deliberate breach of contract, fraud could be relevant in deciding whether the guilty party has evinced an intention no longer to be bound by the contract.

(b) The discussion in the context of insurance contract

[4.66] In *The Captain Panagos DP*,[136] Evans J was of the view that making fraudulent claims is likely to be fundamental and so give insurer the right to elect whether or not to accept the breach as discharging him from further performance of the contract, at least where other primary obligations remain to be performed. A more detailed analysis has been employed in *Orakpo v Barclays Insurance Services* on this subject.[137]

[135] *Hong Kong Fir Shipping v Kawasaki Kisen Kaisha* [1962] 2 QB 26

[136] [1986] 2 Lloyd's Rep.470, 511-512

[137] [1994] CLC 373

[4.67] In this case, Mr. Orakpo was the owner of a large house divided into 13 bed sitting rooms. He insured the property and cover was provided by a number of companies. In early 1985, Mr Orakpo described the property in the proposal form as being in a good state of repair, though at that time the building was already dilapidated. In July 1985, the Local Authority served a repair notice, but the repairs were not carried out. In January 1987, frost damage to pipes caused flooding and subsequent damage. At that time, three tenants were in occupation. In October 1987, storms damaged the roof to the property, causing further extensive damage. The last tenant left shortly after that and vandals caused damages. In March 1988, Mr Orakpo made a claim, against his insurers, which included the damages attributable to storm and burst pipes, works attributable to dry rot and vandalism, works relating to contents and maintenance, professional fees and a claim for loss of rent for two years and nine months of about £77,000 plus VAT. The total loss pleaded in the statement of claim was about £265,000 plus interest.

[4.68] The High Court found that there was material misrepresentation regarding the state of repair in the proposal and the part of the claim based on loss of rent was grossly exaggerated. The size of the loss of rent claim as presented to insurers assumed that all 13 bedrooms would have been fully occupied for the two years and nine months; however there were only three tenants. Mr Orakpo's appeal was unsuccessful. On the non-disclosure point the Court of Appeal agreed there was no estoppel and insurers' defence of misrepresentation was successful. The majority of the Court of Appeal agreed that the claim was fraudulent due to substantive exaggeration, despite that there was no express fraudulent claims clause, the insurers were still able to discharge from liability under the policy. Therefore, nothing was payable to Mr Orakpo.Hoffmann LJ's trenchant comment, *obiter dictum*, revealed a great deal on the nature of this term:[138]

> "Any fraud in making the claim goes to the root of the contract and entitles the insurer to be discharged."

[138] *Ibid*, 383

This makes no doubt that if a term is implied preventing the insured from submitting fraudulent claim, that term is likely to be regarded as a condition.

[4.69] It is suggested that possibility may exist to have the contract being discharged automatically as of the date of the fraud.[139] Fraud would only have this effect if the relevant terms could be categorized as a warranty of the insurance so that any non-compliance would discharge the insurer from all the liability from the date of the breach and without any need for an election by the insurer.[140]From insurer's point of view, this might be a very attractive suggestion. Express provisions might achieve this goal, but it would be very difficult for insurers to persuade the courts to imply a term as warranty in the sense of insurance law, as it has been noted by Mance LJ that:[141] "English Law is strict enough as it is in insurer's favour. I see no reason to make it stricter."

[4.70] The effect of breach from contractual point of view was fully and elaborately explained by Lord Hobhouse in *The Star Sea*[142], and it would be very helpful to set out the full quotation as follows:

> "Having a contractual obligation of good faith in the performance of the contract presents no conceptual difficulty in itself. Such an obligation can arise from an implied or inferred contractual term. It is commonly the subject of an express term in certain types of contract such as partnership contracts. Once parties are in a contractual relationship, the source of their obligations the one to the other is the contract (although the contract is not necessarily exclusive and the relationship which comes into existence may of itself give rise to other liabilities, for example liabilities in tort). The primary remedy for breach of contract is damages. But the consequences of breach of contract are

---

[139] Foxton, D, *The Post-Contractual Duties of Good Faith in Marine Insurance Policies: the search for elusive principles*, Chapter 4 of *Marine Insurance: Law in Transition*, Thomas, DR (Ed), LLP (2005), 4.90

[140] *The Good Luck* [1992] 1 AC 233

[141] *Friends Provident Life & Pensions Ltd v Sirius International Insurance* [2005] 2 Lloyd's Rep.517, [33]

[142] [2001] 1 Lloyd's Rep.389, [50]

not confined to this. The contractual significance of the breach may go further. It may also amount to a breach of a contractual condition which will excuse or suspend the other party's obligation to continue to perform the contract. It may be a repudiatory breach, or evidence a renunciation, which entitles the other party to terminate the contract and sue for damages. However any such release only applies prospectively and does not affect already accrued rights."

C. The possibility of claiming damages

[4.71] In *London Assurance v Clare,*[143] the court was asked to consider whether or not the costs of investigating a claim which turned out to be a fraudulent one could be recovered as damages for breach of implied term of insurance contract requiring the insured not to fraudulently put forward a claim. Goddard J considered this was a "novel claim", but his Lordship had great difficulty in agreeing with this submission. First of all, it seemed to him that no authority had been cited which would suggest that the courts had ever applied the principle of damages for breach of contract to such a matter. Secondly, he was of the opinion that before insurers can decide whether to pay or how much they are to pay, they must investigate the claim. Accordingly, any costs or expenses they may incur were presumably become part of the costs in the action; their positions would be no different if it had been an honest claim in which case they would still have to investigate it. Thirdly, he thought the damages were too remote to be recovered.

It is submitted, respectfully, that the interpretation of the learned judge might not be fully correct and there is a possibility, despite not strong, that investigation cost can be recoverable in certain circumstances. A case for claiming damages could be made in the following fashion:

[4.72] Firstly, every breach of contract gives rise to claim for damages. "Damages" does not mean narrowly compensatory damages; it means "money awards which

[143] (1937) 57 LI L Rep.254

respond to wrongs".[144] It is well suggested that contracts are made in order to be performed. In the context of insurance contract, qualifications could be added that "insurance contracts are made in order to be performed in good faith". Ordinarily, insurer enters into the insurance contract because he is interested in getting the premium the insured has to offer, and because he places a higher value on insured's performance than on the cost and trouble he will incur.[145] In *Robinson v Harman*,[146] it has been authoritively established that: "where a party sustains a loss by reason of a breach of contract, he is, so far as money can do it, to be placed in the same situation, with respect to damages, as if the contract had been performed." This means the courts' primary duty, is to compare the claimant's present position with the position he would have been in had the defendant performed as required, and to compensate the claimant accordingly. In the current context, it is worthy of attention that the duty of the insured is a negative one: **not** to submit fraudulent claims. If the contract has been performed, there would be no such submission. The insured is in breach because he has made such a submission and investigation costs are incurred as a result, so the insurers should be compensated and placed in the situation as if there is no such submission at all and therefore, investigation costs should be recoverable in order to achieve this purpose.

[4.73] Secondly, it is firmly established that a claimant cannot in all circumstances claim full protection of his performance interest. The law has developed a number of rules for the purpose of limiting damages for breach of contract. For the purpose of current discussion, a claimant cannot recover damages in respect of a loss which is too remote a consequence of the defendant's breach of contract. The classical test of remoteness was formulated in *Hadley v Baxendale*:[147]

> "the damages...should be such as may fairly and reasonably be considered either arising naturally, i.e. according to the usual course of things, from such breach of contract itself,

[144] Edelman, *Gain-based Damages: Contract, Tort, Equity and Intellectual Property*, Hart Publishing (2002), at p.22

[145] See Friedmann, *The Performance Interest in Contract Damages* (1995) 111 LQR 628, 629

[146] (1848) 1 Ex 850, 855 (Parke B)

[147] (1894) 9 Exch 341, 354

or such as may reasonably be supposed to have been in the contemplation of both parties at the time they made the contract as the probable result of the breach."

Put the test in the context of submitting insurance claims, it is suggested that the costs might not be too remote to be recoverable.[148] The logic is actually simple: the insured is entitled to make a claim on the occurrence of a casualty within the range of the insured perils. His duty is to claim only for indemnity against loss. A fraudulent claim cannot be a claim for indemnity and it shall never be submitted by insured to insurer.[149] The insurer will not have to pay the investigation costs but for the presentation of the fraudulent claim. Costs are paid as a natural consequence of submission of fraudulent claims which falls into the first limb of remoteness rule and accordingly, the insurer might be entitled to recover back the costs he paid as damages.

[4.74] It may also need to consider the impact of the House of Lords' decision in *The Achelleas*[150] on the test of remoteness rule. Although Lord Hoffmann and Lord Hope adopted a somewhat new test called "assumption of liability" test into the facts of case, namely, the recoverable loss must be foreseeable and within the parties'

[148] Professor Clarke was of the opinion that the reasoning given by Goddard J cannot stand with the modern contract law, as regards remoteness of damages. Clarke, M, *The Law of Insurance Contract*, 6th edn, Informa (2009), 27-2C5

[149] *Fargnoli v G A Bonus Plc* [1997] CLC 653, 671 (Lord Penrose)

[150] *Transfield Shipping Inc. v Mercator Shipping Inc. (The Achilleas)* [2009] 1 AC 61. The facts of the case are related to whether the shipowner was entitled to claim the loss of profit following a later redelivery of the vessel. Applying Lord Hofmann's assumption of liability test into the case, it was within the contemplation of the parties that late redelivery could affect owner's subsequent contract with other parties. However, the general understanding in the shipping market was that liability was restricted to the difference between the market rate and the charter rate for the overrun period, and the charterers had no control over the subsequent contract and it was completely unpredictable to them at the time of entering into the contract.(e.g. how long is the period; what's the result of inability to deliver). So it could not be presumed that the party in breach has assumed responsibility for any loss resulting from arrangements entered into between the owners and the new charterers.

contemplation to assume the liability,[151] the following judicial opinions are seemingly still stick to the *Hadley v Baxendale* approach that had been taken to remoteness. In *The Amer Energy*,[152] Flaux J said that:

> "To the extent that Lord Hoffmann was purporting to lay down some new text as to recoverability of damages in contract, he was in a minority...in any event it is important to note that even Lord Hoffmann acknowledges in paras 9 and 11o f his opinion that departure from the normal principles of foreseeability would be unusual... [Lord Hoffmann's view] was not a view shared by the majority and it would be heterodox to say the least."

Flaux J's negative comment received some support later in *Classic Maritime Inc. v Lion Diversified Holdings Berhad*,[153] where Cooke J said that it would be surprising if the House of Lords had altered the remoteness test for contract to "assumption of responsibility". Therefore, it is submitted that *Hadley v Baxendale* remains the standard rule as it has provided an established and helpful route and cannot be easily overruled. The analysis above in relation to the remoteness of recoverability of investigation cost will not change much in the light of the ruling in *The Achelleas*.

[4.75] The third argument supporting the recovery of investigation costs might be very difficult to make in English commercial law and will be hotly disputed, but a few passing-line observations could be drawn in the following part, namely, investigation costs might be recovered by way of punitive damages.

---

[151] In *The Achilleas*, Lord Roger and Lady Hale adopted the traditional approach, ruling that the loss of profit was irrecoverable because it did not occur "in the ordinary course of things"(the first limb of *Hadley v Baxendale*). It occurred only because of the "extremely volatile market" condition: the volatility of the market was not an ordinary arising loss and it was not known to the defendants at the time the contract was entered into. Therefore, the loss was not foreseeable and too remote. Moreover, Both parties would have known that late delivery was likely to mean a follow-on charter was cancelled, and if the charterparty want to exclude his liability, it is very easy for him to insert a clause to exclude this, but they did not, which means the parties had not previously thought about it: not within the contemplation of both parties.

[152] *ASM Shipping Ltd of India v TTMI Ltd of England (The Amer Energy)* [2009] 1 Lloyd's Rep.293

[153] [2010] 1 Lloyd's Rep.59

Compensation for loss or damage caused by wrongful conduct is not the only legitimate purpose for award of damages in a civil suit. Where a legal wrong has been committed but no consequential loss has been caused, it has been long established in common law jurisdiction that damages could be awarded. The purpose of the award is vindicatory: to mark the existence of the right in question.[154] Put it in the context of insurance contract law, that is to say, to mark the existence of the right of insurer to require claims to be submitted honestly.

The consideration of awarding punitive damages was put on certain in *Rookes v Barnard*.[155] Having exhaustively described the history of punitive damages, Lord Devlin came to four conclusions: firstly, punitive damages could not be said to have no part to play in English Law; secondly, they differed from aggravated damages in that they were overtly retributory rather than aimed at compensating for distress or humiliation; thirdly, exemplary damages were anomalous, representing as they did an incursion of criminal thinking into private law; fourthly, they were only available in precise and limited circumstances. However, in 1997 the Law Commission launched an investigation and argued that penal considerations should have a more extensive part to play in the law of obligations generally than Lord Devlin thought they should. The Law Commission suggested that punitive damages shall be available for any egregiously or outrageously wrongful act.[156] The view was supported in *Kuddus v Chief Constable of Leicestershire*. Lord Nicholls said:[157]

> " [The availability of punitive damages] should be co-extensive with its rationale. As already indicated, the underlying rationale lies in the sense of outrage which a defendant's conduct sometimes evokes, a sense not always assuaged fully by a compensatory award of damages even when the damages are increased to reflect emotional distress...There is no obvious reason why, if exemplary damages are to be available, the profit motive should suffice but a malicious motive should not."

---

[154] See Scott, *Damages* [2007] LMCLQ 465

[155] [1964] AC 1129

[156] See the Law Commission, *Aggravated, Exemplary and Restitutionary Damages*, Law Com. No.247 (1997)

[157] [2002] 2 AC 122, 144-145

Although submitting a fraudulent claim may contain both a profit and malicious motive, it is suggested that awarding punitive damages are highly exceptional in the case of breach of contract. It is also submitted that the fact that a breach of contract has been committed with a view to profit has not been accepted as sufficient grounds of itself for granting restitutionary damages for it and it is hard to see that the courts would change this stance merely because the claim was put as one for punitive damages.[158] Nevertheless, punitive damages are discretionary, depending upon the nature of fraud, it is possible that in the case of wilful destruction of the property, e.g. arson or scuttling, the investigation cost may be awarded as a punitive damages.

[4.76] To sum up, if the duty not to submit the fraudulent claims is implied as a contractual obligation, any breach should sound in damages by way of normal rule of awarding damages (and in a small chance by way of possible punitive damages), despite there are commercial reasons leading the insurer "to prefer not to take an aggressive public stance of this kind".[159]

IV. The Duty of Good Faith

[4.77] Since Lord Mansfield established the doctrine of the duty of utmost good faith, this doctrine has been considered to have an impact primarily in pre-contractual context. In more recent years, the courts started to explore the prospect of extending the doctrine of utmost good faith to post-contractual stage. However, the potential extension is likely to create difficulties particularly in the claims context. A handful of academic and judicial debates have emerged as a result. For the purpose of clarification, it might be convenient to consider the issues in the following order:

1. Whether or not the duty of utmost good faith continues after the contract is formed?

---

[158] Tettenborn, A (Ed), *The Law of Damages*, LexisNexis (2003), 2.38

[159] Clarke, M, *The Law of Insurance Contracts*, 6th edn, Informa (2009), 27-2C5

2. Whether or not the submission of fraudulent claims constitutes a breach of continuing duty of utmost goods faith?

3. What remedies are therefore available to the insurer in the event of breach of post-contractual duty of utmost good faith?

4. What are the drawbacks of the current law position and would it be possible to correct or reform them?

A. The duty of utmost good faith continues after the formation of contract: From *The Litsion Pride* to *The Mercandian Continent*

[4.78] There can be no question that Lord Mansfield's decision in *Carter v Boehm*[160] in 1766 is a landmark in the development of insurance law. The principles of good faith have been introduced systematically into English Law over the years since then. Although Lord Mansfield was of the opinion that the duty of good faith is the "governing principle applicable to all contracts and dealings", this principle has particular resonance in the field of insurance contracts for the responsibilities of insured. It is characteristic of such transactions that many facts necessary to a proper assessment of the risk being undertaken by the insurer exist peculiarly within the insured's private knowledge. An insurer characteristically relies, and must be entitled to rely, on the insured's having disclosed and fairly represented such matters. If the insured fails to disclose them, whether by accident, negligence or fraud, and the insurer is induced by his ignorance to contract under a misapprehension as to the nature of the risk being run, the insurer could deny liability.[161]

[4.79] There can also be no doubt that Sir Mackenzie Chalmers' codification of existing state of law in 18th and 19th centuries, which turned out to be the Marine Insurance Act 1906, stands for the new age of insurance law. In particular, Section 17,

---

[160] (1776) 3 Burr.1905. For a detailed examination of this case, see Watterson, S, *Carter v Boehm (1766)*, Chapter 3 of *Landmark Cases in the Law of Contract*, Mitchell, C& Mitchell, P(Ed), Hart Publishing(2008)

[161] *Ibid*, 1909-1910

in general and extremely wide but simple and concise words, transforms the opinions of Lord Mansfield in *Carter v Boehm* into legislation, providing 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." Although the words refer to "marine insurance contract" only, the principle is accepted as expressing generally applicable insurance principles.[162]

[4.80] Following Section 17, Sections 18-20 formulate the pre-contractual duty of utmost good faith on the part of insured and his agent. However, the Act says nothing about whether or not Section 17 imposes a continuing duty of utmost good faith after the formation of the insurance contract. Upon the proper interpretation of the Act[163], on the one hand, it is interesting to see that Section 17 is placed under the heading of "Disclose and Representations" and before Sections 18-20, which could potentially suggest that Section 17 is just intended to be an introduction to Sections 18-20 and therefore applies only at pre-contractual stage but does not have any post contractual dimensions. Moreover, it could equally be submitted that if Section 17, which does not refer to a time limitation as to the duration of the duty, had been intended to apply purely pre-contractual, why Sir Mackenzie Chalmers did not restrict its application by using the phrase "before the contract is concluded."? Furthermore, it is also obvious to see that Section 17 illustrates a duty which is beyond the particular instances of the duty laid down by Sections 18-20. For instance, it is a duty owed by both the insured and the insurer, and the remedy will be invoked if either party fails to comply with the duty, but Sections18-20 concern only with the duty of insured. When describing the nature of Section17, Sir Mackenzie Chalmers illustrated in his book: "The general

[162] *HIH Casualty and General Insurance Ltd. and Others v Chase Manhattan Bank and Others* [2003] 2 Lloyd's Rep.61, [5] (Lord Bingham)

[163] In respect of the principles of interpreting a codifying act, it is suggested in *Sanday & Co v British & Foreign Marine Insurance Co* [1915] 2 KB 781, 786 that "the proper course is in first instance to examine the language of the statue, and to ask what is the natural meaning, uninfluenced by any considerations derived from the previous state of law, and not to start with inquiring how the law previously stood."

principle is stated in this section because the special sections which follow are not exhaustive."[164]

(a)*Black King Shipping Corporation v Massie (The Litsion Pride)*[165]

[4.81] The prospect of attributing a post-contractual dimension to the duty of utmost good faith was first considered in the case of *The Litsion Pride.*

The vessel *Litsion Pride* was insured under a marine insurance policy which provided that, in the event of the vessel entering a number of specified areas, in particular, ports in the Gulf area during the war, notice was to be given to the underwriters as soon as practicable and an additional premium was to be adjusted for the duration of the vessel's stay in that area. On 2 August, *The Litsion Pride* sailed into the Persian Gulf without declaring the voyage to the underwriters or paying the additional premium, as was obligatory under the terms of the policy. On 9 August, the vessel sank, having been struck by a missile. On 11 August, a telex was sent to the brokers by the shipowners informing them that a letter regarding the imminent entry of *The Litsion Pride* into the Gulf had been written, but not sent by oversight. The letter was dated 2 August and did not reach the underwriters until after the casualty. The mortgagees, standing in the shoes of the owners, claimed under the policy, but the insurers declined payment on the grounds of breach of the duty of utmost good faith.

[4.82] The court gave the judgement in favour of the underwriters, finding on the evidence that the shipowners had sought to support their claim with fraudulent documents, such as the purportedly backdated letter of 2 August. Firstly, Hirst J elaborated that Section 17 is overriding and imposes a continuing duty on both parties to observe utmost good faith;[166]Secondly, the extent and scope of the duty is all-embracing, capable of covering a wide range of subjects, including a continuing duty

[164] Chalmers & Owen, *The Marine Insurance Act 1906*, London (1907)

[165] [1985] 1 Lloyd's Rep.437

[166] *Ibid.*, 511

of disclosure and a duty not to make fraudulent claims. Under the duty to observe utmost good faith, relevant information may have to be disclosed at certain points. For example, at the time of renewal of the policy; when a vessel intends to enter an additional premium area under a trading warranty; when required by held covered clause;[167] Thirdly, the effect of a breach of Section 17 on the particular claim and/or on the contract policy as a whole were also considered under the rule of avoidance. Avoidance in Section 17 means avoidance *ab initio*, and there is no reason for putting a different meaning on the word in relation to post-contractual events.[168]

[4.83] The troublesome aspect of Hirst J is that his Lordship held whenever there is a contractual requirement for the insured to give the underwriter information which is material in the sense that it would influence the judgement of a prudent underwriter in making a decision under the contract for which the information is required, the continuing duty of utmost good faith requires the insured to make full disclosure of all material facts, whether or not he realizes their materiality, and not simply to refrain from dishonest, deliberate or culpable concealment. Hirst J based his decision on three principles: (a)Section 17 of Marine Insurance Act 1906 was not confined to pre-contractual matters; (b) there were various cases in which the courts had, after a loss, ordered a marine insured to provide the insurers with ships papers and his Lordship classified this duty as being based on utmost good faith;[169] (c) there were cases in which an insured had sought to exercise his right under a held covered clause, and to obtain extended coverage on offer under the contract by giving notice to the insurers and paying any additional premium required.

[4.84] The arguments were not particularly solid: in respect to (a), the part of the Marine Insurance Act 1906 in which Section 17-20 appear is headed "Disclosure and Representations", so it could be argued that nothing more than pre-contractual matters were in the ambit; with regard to (b) it seems this should be treated as nothing more

[167] *Ibid.*, 512

[168] *Ibid.*, 515

[169] *Ibid.*, 510-511

than procedure issues as opposed to the application of utmost good faith; and (c) can be regarded as a fresh insurance contract to which the ordinary pre-contractual duty would apply.

[4.85] Although the conclusion and its reasoning given by *The Litsion Pride* is not convincing, it is nevertheless proved to be a starting point for discussion of the continuing duty of good faith in the later cases. The issue was also considered in the case of *Good Luck.*

(b) *Bank of Nova Scotia v Hellenic Mutual War Risks Association (The Good Luck)*[170]

[4.86] The Ship "*The Good Luck*" was insured against war risks with the defendant's club and mortgaged to the bank. The club cover contained an express warranty prohibiting the vessel from entering certain declared areas but further provided that should the vessel enter those additional premium areas (APA), prompt notice was to be given to the club. If no notice was given, the club would be entitled to reject any and all claims arising out of events occurring while the vessel was in an APA. The club gave a letter of undertaking to the bank, whereby the club promised to advise the bank promptly if it should cease to insure the ship. The ship entered a charterparty to trade in Gulf area (APA) but neither the bank nor the club was informed. Furthermore, when the club eventually became aware of the trading pattern of the ship, it took no steps either to prohibit the ship from carrying on the voyage or to inform the bank. At that time, the shipowners were renegotiating their loans with the bank; the bank knew the ship was trading in the Gulf, but had assumed that the shipowners were paying the additional premium, and on this basis they advanced more money. At later stage, the ship was hit by a missile and became a constructive total loss. The club rejected the claim, because no notification had been given to them

[170] [1988] 1 Lloyd's Rep.514 (the High Court); [1989] 2 Lloyd's Rep.238 (the Court of Appeal); [1991] 2 Lloyd's Rep.191 (the House of Lords) The issue of a continuing duty of utmost good faith was considered by Hobhouse J in the High Court and May LJ in the Court of Appeal, but was not considered by the House of Lords.

according to the terms of the cover. However, the club was sued by the bank on the basis that, *inter alia*, the club was liable for breach of a continuing duty of utmost good faith in failing to disclose what it knew to bank.

[4.87] The argument was rejected both in the High Court and the Court of Appeal. Hobhouse J acknowledged the duty of utmost good faith can continue after the conclusion of contract:[171]

> "Contracts of insurance are contracts of the utmost good faith. The obligation of the utmost good faith is one which arises normally in relation to the making of the contract. This is because that is the situation in which the duty is most usually relevant. But, as was stated by Mr. Justice Hirst in *The Litsion Pride*, the duty exists throughout the contract."

But he ruled that the club did not owe to the bank a duty of the utmost good faith; the letters of undertaking were not contracts of the utmost good faith; under the insurance contracts themselves there were mutual duties of the utmost good faith as between the club and the mortgagors; the club had not broken its duty to the mortgagors and owed no separate duty to the bank. The ruling was supported by the Court of Appeal. May LJ stated that:[172]

> "We do not think it is necessary to question the decision of Mr. Justice Hirst in *The Litsion Pride* so far as concerns his decision that the obligation of utmost good faith could continue after the contract was made with reference to such a matter as the fixing of the rate of additional premiums."

[4.88] Over the past two decades, particularly after the judgement by Hirst J in *The Litsion Pride*, the courts have expressed considerable opinions on this issue and intense academic discussions were carried out. Even though most comments were *obiter*, the judicial trend was to indicate that the duty of utmost good faith should not cease to exist upon the conclusion of contract but should influence the performance of

[171] [1988] 1 Lloyd's Rep.514, 545

[172] [1989] 2 Lloyd's Rep.238, 263

contract. It was, for example, identified that the duty of utmost good faith applies where an insured has the obligation to give notice when seeking to take advantage of a held cover clause in an existing policy[173] and Section 17 has repeatedly been held to be applicable in the context of claims.[174] At last, the House of Lords had an opportunity to express an opinion on the matter in *The Star Sea.*

(c) *Manifest Shipping and Co Ltd v Uni-Polaris Insurance Co (The Star Sea)*[175]

[4.89] Three ships, the *Star Sea*, the *Centaurus* and the *Kastora* were beneficially owned by the Kollakis family. Each was registered under a one-ship company, which -in the case of the *Star Sea* - was Manifest Shipping Ltd. A group insurance cover had been renewed for another year over the 40 vessels in the fleet. All three ships were effectively managed by Kappa Maritime Ltd., the directors of which were members of the Kollakis family and Mr. Nicholaidis. The registered managers were a Greek company whose directors were Captain Kollakis and Mr. Faraklas. The latter was the sole director of the claimant, Manifest Shipping. A year before this insurance policy was renewed; there was a fire in the engine room of the *Centaurus*. The engine room could not be effectively sealed and the Korean crew did not use the CO2system to extinguish the fire. The ship became a constructive total loss. Within two months from the first incident, the *Kastora* ship became also a constructive total loss due to an engine room fire, which was not put out by her Korean crew. This time the crew used the CO2 system but it was not effective because the funnel dampers were not closed. A surveyor appointed by the managers of the vessel, Kappa Maritime, found the dampers in poor condition. The directors of the claimants and of both managing companies were aware of these facts. As they were not happy with the Korean crews in the fleet, they changed over to having entirely Greek officered vessels. The captain

[173] *Overseas Commodities Ltd. v Style* [1958] 1 Lloyd' s Rep. 437; *Liberian Insurance Agency Inc. v Mosse* [1977] 2 Lloyd's Rep.560

[174] *The Michael* [1979] 2 Lloyd's Rep.1; *Orakpo v Barclays Insurance Services* [1995] LRLR 443; *Galloway v Guardian Royal Exchange* [1999] Lloyd's Rep.IR 209

[175] [1995] 1 Lloyd's Rep.651 (High Court); [1997] 1 Lloyd's Rep.360 (Court of Appeal);[2001] 1 Lloyd's Rep.389(House of Lords) A more detailed research, see Soyer, B, *The Star Sea-a lode star?* [2001] LMCLQ 428

appointed to the *Star Sea* was experienced and competent. However, no steps were taken by the relevant directors to check his knowledge of the right way to use the CO2 system. Furthermore, no special steps were taken to ensure the maintenance of the engine room equipment and to instruct the superintendents to check the state of the dampers.

Deficiencies in the *Star Sea's* emergency fire pump were found in January 1990, when a Belgian port authority surveyor inspected her after her arrest by cargo claimants. During repairs of the fire pump, which were eventually completed, the chief engineer cut a suction pipe passing through the forepeak ballast tank to a non-return valve in the ship's side. This pipe was never repaired and, as it transpired later, this affected the ship's seaworthiness. On May 27th 1990, the *Star Sea* sailed from Nicaragua bound for Zeebrugge with a full cargo of bananas, mangoes and coffee. Two days later, as she was approaching the Panama Canal, a fire started in the engine-room. The fire spread and was not put out for several days. It caused extensive damage to the vessel, so as to render her a constructive total loss.

[4.90] The insured shipowners, Manifest Shipping Ltd., claimed under the insurance policy against the underwriters, who pleaded, in reliance on Section 39(5) of the Marine Insurance Act of 1906, that the ship was sent to sea in an unseaworthy condition with the privity of the insured and/or that the insured was in breach of his duty of utmost good faith under Section 17 of the Act. The underwriters' case with regard to breach of Section 17 related to (a) the fact that the insured did not disclose in witness statements , which were exchanged before trial, about facts concerning defects in the dampers of the *Kastora,* which were reported in the expert's second report;(b) the fact that they did not disclose the expert's reports concerning the *Kastora* casualty, the allegation being that the insured's solicitors consciously decided to treat them as 'privileged' having appreciated that disclosure of these reports would weaken their clients' case in this litigation; and (c) misleading information given by the insured's brokers about the *Kastora* casualty. There was no allegation, at any stage, that the claim was put forward fraudulently, namely without an honest belief that it was a claim the insured was entitled to make.

[4.91] Three Law Lords delivered the judgements. Lord Clyde was of the opinion that the solution to impose a limit upon the period of the relationship between the parties to which the statutory provision is meant to apply so that it would only apply to the pre-contract negotiations appeared to be past praying for, and a flexible construction of concept of utmost good faith should be adopted.[176] His Lordship also proposed an open-ended suggestion that the concept of good faith in insurance contracts reflects the degree of openness required of the parties in the various stages of their relationship. The substance of the obligation which it entails can vary according to the context in which the matter comes to be judged. For example, a high degree of openness is required at the formation of contract stage, but there is no justification for requiring that degree necessarily to continue once the contract has been made[177]. Lord Hobhouse, who delivered the leading judgement of the House, concluded that there are many judicial statements that the duty of good faith can continue after the contract has been entered into, and having a contractual obligation of good faith in the performance of the contract presents no conceptual difficulty, although the content of the obligation to observe good faith has a different application in different situations[178]. Lord Scott considered that it is acceptable that Section 17 the duty of utmost good faith continues to apply after the conclusion of the insurance contract but the content of the post-contractual duty of utmost good faith must be examined afresh and is not coloured by the extent of the duty owed by the insured pre-contract.[179]

[4.92] Their Lordships in *The Star Sea* appeared to admit the existence of post contractual duty of utmost good faith conceptually, but the opinions were apparently with great caution and much reluctance, particularly in respect of the remedies available to the breach, which will be discussed in details below. Despite their Lordships brought further uncertainties to this area of law, there was one certainty point firmly established: in any event when a writ is issued and once the parties are in

[176] [2001] 1 Lloyd's Rep.389, [6]

[177] *Ibid.*, [7]

[178] *Ibid.*, [48] and [50]

[179] *Ibid.*, [95] and [96]

litigation it is the procedural rules and the orders which the court makes on the application of one or other party which govern the extent of the disclosure that should be given in the litigation, not just Section 17 as such, though the concept of good faith will be relevant when the judge exercises his discretion as to whether or not to enforce a particular procedural rule.[180]

A useful supplementary comment on the issue of the continuing duty of good faith was given in slightly later case of *The Mercandian Continent*.

(d) ***K/S Merc-Scandia V. Lloyd's Underwriters (The Mercandian Continent)***[181]

[4.93] This case concerned a claim for indemnity under a third party liability insurance obtained by ship-repairers based in Trinidad, for negligence that occurred during repairs of a vessel. Liability arose to the claimant shipowners under the ship-repair contract. The claimants obtained leave to serve English proceedings out of the jurisdiction against the insured ship-repairer, relying on an English jurisdiction agreement entered into between the shipowners and the ship-repairers' assistant manager. The ship-repairers and their liability underwriters had been (incorrectly) advised by Trinidad lawyers that there would be a limitation of time advantage, if the case against the ship-repairers proceeded in Trinidad. Accordingly, the solicitors for the ship-repairers challenged English jurisdiction, alleging the lack of authority of the assistant manager. In support of this, the managing director and the chairman of the ship-repairers concocted a forged letter. The discovery of the forgery caused the application to be set aside, the writ to be abandoned and the underwriters withdrew from the liability litigation. The ship-repairers were found negligent in the liability action and judgment was given in favour of the shipowners. The ship-repairers went into liquidation and the shipowners obtained a winding up order against them. This enabled the shipowners to proceed against the ship-repairers' liability underwriters,

---

[180] *Ibid.*, [77] (Lord Hobhouse who is "strongly of the view") and [110] (Lord Scott). Those procedures probably refer to Civil Procedure Rules (CPR): Part 31, Disclosure and Inspection of Documents, in particular, Rule 31.23; and Part 32: Evidence, in particular, Rule 32.14

[181] [2000] 2 Lloyd's Rep.357 (High Court); [2001] 2 Lloyd's Rep.563 (Court of Appeal). The case is further analyzed below, at [4.114]-[4.120]

pursuant to the provisions of the Third Parties (Rights against Insurers) Act 1930. In the light of the forgery by the insured ship-repairers, which took place during the litigation between shipowners and ship-repairers, the underwriters avoided the policy and, in the claim against them by the shipowners, raised the defence they would have had against their insured, *inter alia*, namely breach of Section 17 of the Marine Insurance Act 1906.

[4.94] The trial judge Aikens J delivered his opinion on the nature of the post-contractual duty of utmost good faith: [182]

> "The duty on the assured is to refrain from a deliberate act or omission which is intended to deceive the insurers through either positive misrepresentation of facts or by concealment of facts. But the duty does not apply to all facts that might be deliberately misrepresented to insurers or concealed from them by the assured. The facts have to be 'material' in the sense described above. Either there is no duty in relation to immaterial facts or there is no breach of the duty which gives the insurer a right to avoid the policy if there is misrepresentation or concealment of immaterial facts."

The conclusion summarized in this way was agreed with by Longmore LJ who delivered the leading judgement in the Court of Appeal. The counsel's submission that there are only some occasions when the requirement of good faith exists post-contract was rejected and the submission that the duty is a continuing one was accepted.[183]

[4.95] It seems now well-established that after the conclusion of the insurance contract, the parties owe each other a duty to refrain from being fraudulent in the performance of contract or their dealings in connection with the contract. Accordingly, the duty of utmost good faith is required to be observed in the following situations:[184]

A. When the insured (or indeed the insurer) seeks to vary the contractual risk;

---

[182] [2000] 2 Lloyd's Rep. 357(High Court), 378

[183] [2001] 2 Lloyd's Rep.563 (Court of Appeal), [39]-[40]

[184] *Ibid.*, [22]

B. When the insured seeks to renew the contract of insurance
C. When there is the requirement that an insurer holds the insured covered in certain circumstances.
D. When insurer asks for information during the policy by virtue of an express or an implied term, typically in liability policies and reinsurance contracts.
E. Other situations in particular under liability policies where the insurer decides to take over the insured's defence to a claim.
F. Fraudulent claims, which is debatable and will be analyzed in details later in this part

It is suggested that the list might be open-ended, allowing each case to be decided on its own facts.

B. The policy concerns supporting the presentation of fraudulent claims being a breach of continuing duty of utmost goods faith

[4.96] Within the contents of post-contractual good faith obligation enumerated above, as it is submitted by Longmore LJ, variations to the risk, renewals of the risk and additions to the risk under held cover provisions are essentially the example of concluding a new contract. The only post-inception situations where it is obvious and easy to see the operation of duty of utmost good faith are those in which information is exchanged or money is spent dealing with a claim made by or against the insured,[185] and it is well argued that submission of fraudulent claims indeed is in breach of continuing duty of utmost good faith, because it fits the purpose of duty of utmost good faith.

[4.97] It is submitted that there are two reasons putting forward which can justify the existence of the duty of utmost good faith. In the first place, the informational asymmetry nature of insurance contracts requires the insured to act honestly. During the pre-contractual stage, the insurer knows nothing but the insured knows everything

---

[185] *Ibid.*, [31]. See also Longmore, *Good faith and breach of warranty: are we moving forwards or backwards* [2004] LMCLQ 158, 169

about the risk he wants to insure and he must disclose to the insurer every fact material to the risk, as Lord Mustill described that: [186]

> "The inequalities of knowledge between assured and underwriter have led to the creation of a special duty to make accurate disclosure of sufficient facts to restore the balance and remedy the injustice of holding the underwriter to a speculation which he had been unable fairly to assess."

[4.98] By way of analogy, during the claim stage, when a claim initially comes in front of insurer, he is likely to have little knowledge, if any, about the casualty and insured must have relatively more information on this point, thus it makes sense that the informational asymmetry position between two parties with regard to surrounding circumstances of claim shall be balanced, at least, by way of insured acting honestly. In *Galloway v Guardian Royal Exchange (UK) Ltd*, Lord Woolf MR confirmed the rational on this assumption: [187]

> "The position is that the contract remains one of good faith and the insured is required to exercise good faith in the making of the claim. In the making of the claim the facts are normally wholly within the insured's knowledge. The insurers are dependent on the insured exercising good faith in order to evaluate the claim."

[4.99] Similarly, in *Fargnoli v G.A. Bonus plc*, Lord Penrose in the Court of Session said that:[188]

> "I incline to the view that the duties associated with making the claim reflect the character of the contract, and are duties of utmost good faith. Not only does the insured have control of the information required at the outset for the assessment of risk, if a casualty should occur he has at the date of making the claim exclusive control of the information on which the claim must be based. The insured is, typically, the dominate

---

[186] *Pan Atlantic Insurance Co. Ltd. and Another v Pine Top Insurance Co. Ltd* [1994] 2 Lloyd's Rep. 427, 447

[187] [1999] Lloyd's Rep.IR 209, 214. The reasoning was argued in Chapter Five by the author from the perspective of economics. See Chapter Five, at [5.15]-[5.22]

[188] [1997] CLC 653, 673

party in terms of having available relevant information. The risk of fabrication in such circumstances is real."

[4.100] Furthermore, the duty of utmost good faith was originally designed to prevent fraud.[189] Presentation of fraudulent claims, being a very clear-cut type of fraud, ought not to be excluded from the cover of Section 17.

[4.101] To sum up, there are policy concerns supporting to categorize the presentation of fraudulent claims as a type of the breach of Section 17, but why the dominate views are still inclined to the exclusion of fraudulent claims from the sphere of Section 17, as Mance LJ tentatively suggested in *Agapitos and Agnew*[190] that the making of fraudulent claims including the use of fraudulent device shall be outside the scope of Section 17 and governed by common law rule? The concerns concentrate upon the remedy of breach of Section 17 which could operate harshly on the guilty insured and accordingly, it is argued that the solutions should focus on the possible reform of remedies of Section 17, rather than simply hold that fraudulent claim should not trigger Section 17.[191]

C. Current remedy available for breach of the post-contractual duty of good faith: avoidance *ab initio*

[4.102] If presentation of fraudulent claims constitutes the breach of the duty of post-contractual utmost good faith under Section 17 of Marine Insurance Act 1906, the remedy should naturally only be avoidance *ab initio* pursuant to the wording of Section 17.

[189] *Carter v Boehm* (1766) 3 Burr.1905, 1918: "The reason of the rule against concealment is, to prevent fraud and encourage good faith."

[190] [2002] 2 Lloyd's Rep.42, 53

[191] However, the drawbacks of the reform on Section 17 is argued below by the author at [4.153]-[4.156]

[4.103] However, this umbrella doctrine brings at least two problems in the post-contractual context. Firstly, it is suggested that avoidance *ab initio* is normally applicable for vitiating factors which induce a party's consent to contract, such as non-disclosure and misrepresentation. Fraud in the performance of contract may not attract this application. Secondly, the draconian consequence of breach led the House of Lords doubt whether it could be justified to apply avoidance *ab initio* even in the case of presentation of fraudulent claim. Lord Hobhouse clarified this criticism as follows:[192]

> "The Courts have consistently set their face against allowing the assured's duty of good faith to be used by the insurer as an instrument for enabling the insurer himself to act in bad faith. An inevitable consequence in the post-contract situation is that the remedy of avoidance of the contract is in practical terms wholly one-sided. It is a remedy of value to the insurer and, if the defendants' argument is accepted, of disproportionate benefit to him; it enables him to escape retrospectively the liability to indemnify which he has previously and (on this hypothesis) validly undertaken."

[4.104] In respect of the first point, it may be arguable that (a) in light of the actual decision of Lord Mansfield in *Carter v Boehm*, the justification of avoidance is not the element of inducement but the existence of an inequality of accessible information bearing on the contract's subject-matter and the risk undertaken, which rendered the insurer dependent upon the honest behaviour of insured. This rational applies equally to pre-contractual non-disclosure, misrepresentation and post-contractual presentation of fraudulent claim; (b) being a contract founded upon utmost good faith, fraud strongly shakes this premise and, therefore, may nevertheless trigger the application of Section 17 resulting in avoidance of the insurance contract.

[4.105] The second point may highlight the current unsatisfactory position of law. Indeed, the idea that fraud in the claim process enables the insurer to avoid the contract *ab initio* may obligate the insured to refund payments he received on previous claims which were perfectly valid and untainted by fraud. Such result is

[192] [2001] 1 Lloyd's Rep.389, [57]

clearly unjustified, particularly when the policy runs towards the end, the end-of-policy claim is fraudulent but all the claims made before are perfectly legitimate.[193] The legal nature of such idea is punitive with the intention to punish, but it is well recognized that the award of civil courts of punitive remedy is anomalous. However, the question is not whether this punitive remedy is in accordance with principle-it is not-but whether this remedy serves a useful purpose and should be perpetuated.[194]Again, this draconian rule is designed for deterrence of fraud with the purpose to protect and promote the development of insurance industry. The underlying policy was summarized in an old case *Chapman v Pole*, where Cockburn CJ said that:[195]

> "The rate of insurance is calculated upon the average of losses as compared with profits; and the more the company is subjected to deception and fraud the higher the rate of premium which they are obliged to charge. Therefore, the public have an interest in such cases, and the company is bound to defend them when they have fair ground for so doing."

[4.106] This rational was repeated in *Galloway v Guardian Royal Exchange (UK) Ltd*[196]where Millett LJ said:

> "The policy is avoided by breach of the duty of good faith which rests upon the insured in all his dealings with the insurer. The result of a breach of this duty leaves the insured without cover...The making of dishonest insurance claims has become all too common. There seems to be a widespread belief that insurance companies are fair game, and that defrauding them is not morally reprehensible. The rule which we are asked to enforce today may appear to some to be harsh, but it is in my opinion a necessary and salutary rule which deserves to be better known by the public."

---

[193] In the opinion of Lord Mance, avoidance is a singularly blunt and inapposite weapon, especially if made available by a single false claim late in the currency of a long running policy. Mance, *The 1906 Act, common law and contract clauses-all in harmony?* [2011] LMCLQ 346, 355

[194] Scott, *Damages* [2007] LMCLQ 465, 469

[195] (1870) 22 LT 306, 307

[196] [1999] Lloyd's Rep.IR 209, 214

[4.107] Nevertheless, as it will be demonstrated below, it is suggested that even if avoidance could be invoked in post-contractual context, it needs to be restricted or it cannot be used on its own but must be with other remedies. Four restrictions will be introduced in the following sections with their merits and defects, but ultimately, it will have to admit that avoidance is still not the proper remedy for fraudulent claims.

D. Restriction on avoidance

(a) Loss of right to avoid the policy following a fraudulent claim

[4.108] Even if avoidance is the remedy for presentation of fraudulent claims, it certainly does not mean the policy will be nullified from the beginning automatically. The insurers have to choose whether to affirm or to avoid the contract, and their right to avoid may be lost following a fraudulent claim by three ways: by reason of a binding compromise agreement, on the ground of waiver by election and on the basis of waiver by estoppel . Each of these possibilities was considered by HHJ Gibbs QC in *Baghbadrani v Commercial Union.*[197]

[4.109] In this case, in December 1991 a private school was badly damaged by arson, committed by persons unconnected with the insured, the owner. The insured claimed on his insurance with the insurers in relation to material damage and business interruption. The policies provided a standard fraudulent clause which stated that all benefits were to be forfeited under the policies in the event that a claim is fraudulent or if any fraudulent means or devices be used to obtain any benefit under the policy. At first the insurers indicated that they wished to take a number of defences but following further investigations these defences were not pursued although the claim remained unpaid. The insured threatened the issue of proceedings unless matters could be resolved by October 30, 1992. On November 18, 1992, the insurers wrote that it was not their intention to maintain their denial of liability, and that loss adjusters had been instructed to negotiate a settlement as soon as possible. Whilst the loss adjustment continued, and to the adjuster's knowledge, the insurers' solicitors investigated grounds for denial of liabilities, and liabilities were denied on the basis of

[197] [2000] Lloyd's Rep.IR.94

fraud in 1994. At trial, the insured argued that the insurers were precluded from relying on the allegations of fraud given that the correspondence in October and November 1992 created a binding compromise that the insured would not pursue legal proceedings, in exchange of the insurers' decision of treating the claims as valid, waiving any breaches of the duty of utmost good faith, or was estopped from asserting them. HHJ Gibbs found that both material damages claim and business interruption claim were fraudulent on the facts of the case, which made it essential for the court to rule on the question whether the insurers had lost the right to deny their liabilities.

[4.110] First of all, his Lordship held that there was no compromise agreement. On the factual matrix of the case, the exchange of correspondence had not amounted to a contract because insurers' response in November 1992 had not referred to the claimant's threat in the October 1992 letter to the insurers to commence legal proceedings if there was no satisfactory response by the end of that month. Therefore, such response could not be construed as an acceptance of any form of the offer made by the claimant to drop the legal proceedings if the insurers admitted liability. Even if there had been a binding compromise contract, it would have been voidable for fraudulent misrepresentation because at the time of the contract the claimant insured was still committing the fraud in pursuit of the claim.

[4.111] Secondly, the learned judge was of the opinion that there was no waiver by election. Election waiver requires an unequivocal statement by insurers which would have given the impression to a reasonable man that they are aware of the breach but they do not intend to rely upon their rights in relation to it and they have made an informed choice to accept liability.[198] A statement by insurers that they intended to pay could not be regarded as unequivocal until they had had the opportunity to investigate the claim. In this case, while the insurers had made the representations that the liability had been accepted they had not possessed adequate evidence to make out any allegation of fraud and it would not have been sensible for them to deny liability at that stage, this right of the insurers to have a reasonable time to consider their

[198] *Insurance Corp of the Channel Islands v Royal Hotel Ltd* [1998] Lloyd's Rep. IR.151

position and investigate was confirmed by David Steel J in *Callaghan and Hedges v Thompson.*[199]

[4.112] Thirdly, his Lordship was of the opinion that there was no waiver by estoppel. In principle, waiver by election is established where the insurers have unequivocally represented their intention to pay provided that they have the knowledge that they possess a defence. Waiver by estoppel, by contrast, merely requires an unequivocal statement that the insurers are accepting liability, even if they are unaware of facts which might give them a right to deny liability. In the case of fraud, estoppel would generally be inapplicable, particularly where such fraud continues after the insurers' representation. This is because estoppel is an equitable remedy, and only can be approached by a person who comes to the court with "clean hands".

[4.113] In practice, the possibilities of raising a defence by the insured on the above basis may be quite small, because it is not easy to persuade a reasonable insurer not to advance a thoroughly investigation[200] before he decides to make a payment or reach a compromise with the insured. In addition, considering insurers' general hostile attitude against the fraud, it is difficult to imagine that a reasonable insurer would waive his right after he has known the insured's breach of duty. Accordingly, it seems that the situation of losing the right to avoid might be rare, so other restrictions have to be advanced.

---

[199] [2000] 1 Lloyd's Rep.125

[200] It will be demonstrated from the perspective of economics in Chapter Five that a proper investigation itself is a good way of deterrence of fraud. See Chapter Five, at [5.18]-[5.21]

(b) The *Mercandian Continent* Test

[4.114] The first clearly stated restriction put by the court in order to ensure that the draconian remedy was not used to oppress the insured could be found in *The Mercandian Continent.*[201]The facts of the case have been introduced above.[202]

In this case, The Court of Appeal held that there was a continuing duty of good faith upon the insured ship-repairer under the Section 17 of the Marine Insurance Act 1906, and indeed the insured was in breach of duty in this case. However, the forged letter was not directly relevant to the claim under the policy at all and was not to the insurer's prejudice, which made the court consider it necessary to put limitations on the availability of the remedy. Longmore LJ, who delivered the leading judgement in the Court of Appeal, said:[203]

> "Section 17 states that the remedy is the remedy of avoidance but does not lay down the situations in which avoidance is appropriate. It is, in my judgement, only appropriate to invoke the remedy of avoidance in a post-contractual context in situations analogous to situations where the insurer has a right to terminate for breach. For this purpose (A) the fraud must be material in the sense that the fraud would have an effect on underwriters' ultimate liability,[204] as Rix J held in *Royal Boskalis*, and (B) the gravity of the fraud or its consequences must be such as would enable the underwriters, if wished to do so, to terminate for breach of contract.[205] Often these considerations will amount to the same thing; a materially fraudulent breach of good faith, once the contract had been made, will usually entitle the insurers to terminate the contract. Conversely, fraudulent contract entitling insurers to bring the contract to an end could only be material fraud. It is in this way that the law of post-contract good faith can be aligned with the insurers' contractual remedies. The right to avoid the contract with retrospective effect is, therefore, only exercisable in circumstances where the innocent party would, in any event, be entitled to terminate the contract for breach."

---

[201] [2001] 2 Lloyd's Rep.563

[202] Above, at [4.93]

[203] *Ibid.*, [35]

[204] Hereafter referred to as test (A)

[205] Hereafter referred to as test (B)

[4.115] In this case, Longmore LJ clearly introduced the test of materiality into the post-contractual context. This introduction probably could be traced back to *Royal Boskalis Westminster NV v Mountain*,[206] where Rix J said that a fact would only be material if it had ultimate legal relevance to a defence under the policy. This expression was considered in the context of deliberate and culpable post-contract conduct instead of fraudulent conduct,[207] but later the Court of Appeal in *The Star Sea*[208] was of the opinion that the word "culpable"[209] does not "enlarge the scope of fraud, in which case it is not needed, or it does, in which case the extent of the enlargement is unclear and the concept should be rejected." [210] Thus, Longmore LJ's findings may be justified in this context. However, a few oppositions may be observed as follows:

[4.116] Firstly, the test would not be satisfied in the case of an otherwise genuine claim supported by fraudulent devices or means, as Mance LJ commented that if one were to adopt the test identified in *The Mercandian Continent* in the context of fraudulent devices, "the effect is, in most cases, tantamount to saying that the use of a fraudulent device carries no sanction".[211] As a result, Mance LJ introduced a different test of materiality in the context of fraudulent device so that the courts should only apply the fraudulent claim rule to the use of fraudulent devices or means which would if believed, have tended, objectively but prior to any final determination at trial of the parties' rights, to yield a not insignificant improvement in the insured's prospects.[212]

---

[206] [1997] LRLR 523

[207] In this case, the underwriters alleged non-disclosure amounting to deliberate concealment and misrepresentation amounting to a deliberate lie, and submitted that in relation to each the presentation of the claim was deliberately and culpably misleading and palpably dishonest. Rix J decided on the facts of the case that the plaintiffs were not guilty of making a fraudulent claim but were guilty of deliberate and culpable misrepresentation and non-disclosure.

[208] [1997] 1 Lloyd's Rep.360

[209] *Ibid.*, Leggatt LJ said that the only authority cited to him in which the word "culpably" was used was *The Litsion Pride* [1985] 1 Lloyd's Rep.437

[210] *Ibid.*, 372

[211] *Agapitos v Agnew* [2002] 2 Lloyd's Rep.42, [37]

[212] *Ibid.*, [38]

It is further suggested that the test would never be satisfied in the cases in which post-contractual fraud committed were necessarily unrelated to the insurer's liability and would not post a detriment on insurer, such as fraudulent post-contractual declarations made by the insured used for the calculation of premium[213]and, therefore, if the "materiality" test of Longmore LJ was invoked, it seems the remedy will fail to play the role of deterrence of fraud in such kind of cases, which could be an inappropriate and embarrassing result.

[4.117] Secondly, it might be inappropriate to look into the question of avoidance by analogy with termination, which is a completely different concept. On the one hand, termination is used to describe the remedy by which the injured party is released from his obligation to perform because of the other party's defective or non-performance. The effect of termination is prospective. When considering whether or not a breach of contract entitles the innocent party to terminate further performance of the contract, usually two different approaches could be adopted. One approach is to leave it to the parties to decide when the right to terminate will arise. Alternatively, one could leave it to the unfettered discretion of the court to decide whether or not there exists a right to terminate. For the purpose of the latter approach, the court will either focus on the nature of the term broken or the consequence of the breach. Probably it could be concluded that the right of innocent party to terminate derives from the contract itself; it is a contractual remedy. On the other hand, avoidance entitles the innocent party not only to treat himself as being discharged from further liability but can also undo all that has gone before. The effect of avoidance is retrospective. The remedy of avoidance derives from the breach of utmost good faith. In the pre-contractual context, it has been authoritatively determined that the legal basis of the duty of utmost good faith is a rule of law,[214] and it is suggested that there is "no reason why the source in law of the obligation, or the remedy for its breach, should be different after the contract is made, from what it is at the pre-contract

---

[213] Eggers, PM, *Utmost Good Faith and the Presentation and Handling of Claims*, Chapter 10 of *Reforming Marine and Commercial Insurance Law, Soyer, B(Ed), Informa (2008)*

[214] Gilman, J(Ed), *Arnould's law of marine insurance and average*, 18th edn, Sweet&Maxwell (2008), 15-18 to 15-19

stage".[215] Lord Hobhouse also acknowledged this position in *The Star Sea*, saying the remedy of avoidance for breach of the duty of utmost good faith "is difficult if not impossible to justify as an implied term of contract".[216] Thus, probably it could be concluded that the right of innocent party to avoid the contract derives from the rule of law and is not contractual in origin.[217] To sum up, it is theoretically difficult to explain a concept by reference to another concept which has a quite distinct origin and effect. Moreover, it is submitted that unless damages are available for breach of the duty of utmost good faith in post-contractual stage, to limit the post-contractual duty of good faith to repudiatory breaches of contract, would be equally to mean the deprivation of the insurer of any real remedy in the event that the post-contractual fraud is not sufficiently serious to amount to a repudiation.[218]

[4.118] Thirdly, to add test (B) into the context of making fraudulent claims is superfluous, as it has been observed by Hoffmann LJ:[219]"Any fraud in making the claim goes to the root of the contract and entitles the insurer to be discharged", with which Lord Hobhouse agreed in *The Star Sea*:"The fraud is fundamentally inconsistent with the bargain and the continuation of the contractual relationship between the insurer and the assured". [220]

[4.119] Finally, to add tests (A) and (B) into the interpretation of Section 17 of Marine Insurance Act 1906 is to judicially rewrite the legislation, which should always be conducted with great caution. In addition, it also introduces different interpretations upon the same words of the statutory provision depending on whether

---

[215] *The Good Luck* [1990] 1 QB 818, 888

[216] [2001] 1 Lloyd's Rep.389, [51]. The proposition is developed below, at [4.149]-[4.151]

[217] Gilman, J (ed), *Arnould's law of marine insurance and average*, 18th edn, Sweet&Maxwell (2008), 18-14 to 18-18

[218] Eggers, PM, *Remedies for the Failure to Observe the Utmost Good Faith* [2003] LMCLQ 249, 263

[219] *Orakpo v Barclays Insurance Services* [1994] CLC 373, 383

[220] [2001] 1 Lloyd's Rep.389, [62]

the relevant breach is pre-contractual or post-contractual, which is probably an undesirable position.

[4.120] Although it is observed by *MacGillivray* that the paradigm cases of the baseless claim, the inflated claim, and the suppression of a defence would most probably pass not only test (A) but also test (B),[221] there are no reported cases yet in which those two tests are directly applied, which probably reflects the facts that the tests are not only difficult in theory but also stringent in practice. Therefore, other more flexible remedies may be required to fill this blank. At this stage, two possibilities are raised which will be discussed as follows.

(c) Judicial flexibility: discretion to disallow avoidance

[4.121] In an early Law Commission's Report entitled *Insurance Law: Non-disclosure and Breach of Warranty*[222], which was regarded as one of the milestones in the 20th century development of the law of insurance, two proposals in respect of the reform of the doctrine of avoidance were rejected: the first one was the notion of proportionality as espoused in French law[223] and in the then proposed European Directive,[224] and the second one was the idea that the court should be vested with a

---

[221] Legh-Jones, N (Ed), *MacGillivray on Insurance Law*, 11th edn, Sweet&Maxwell (2008), 19-065

[222] Law Com.No.104 (1980). A brief summary and comment on the report, see Longmore, *An Insurance Contracts Act for a new century* [2001] LMCLQ 356

[223] In France, the principle of proportionality is embodied in Code des Assurance, Art.L.113.9. It basically says that in the event of a breach of the duty of disclosure by the insured in circumstances where he may be considered to have acted improperly, "l'indemnité est réduite en proportion du taux des primes payées par rapport au taux des primes qui auraient été dues, si les risques avaient été complètement et exactement déclarés" (the indemnity is reduced in proportion to the rate of premiums paid in relation to premium rates which would have been payable if the risks had been fully and accurately reported.)

[224] Article 3.3 (c) of the *Proposed Council Directive on the Co-ordination of Laws, Regulations and Administrative Provisions Relating to Insurance Contracts* provides that in the case of breach of duty to disclosure on the part of insured, "if a claim arises before the contract is amended or

discretion in a suitable case to adjust the parties' respective responsibilities. The first was rejected for good reasons, as it is submitted,[225] but the second one was not considered in any substantial details because it was the "reasonable insured test" that was proposed by the Law Commission and if an insured cannot recover on that test, he would only have himself to blame.[226] However, as the "prudent insurer test" remains as it is since the decision of *Pan Atlantic*[227], it is suggested that the discretion idea was rejected too readily and a discretionary apportionment of the loss shall be re-considered.

[4.122] In new consultation paper published by the Law Commissions named *Insurance Contract Law: Misrepresentation, non-disclosure and Breach of Warranty by the insured*,[228] the issue of discretion to prevent avoidance in some harsh cases was submitted again.[229] The attitude of the Law Commissions was changed: the consultation paper welcomes views about whether the courts should have discretion to mitigate the harsh effects of avoidance in some cases.

[4.123] The possibility of discretionary control to the right of avoidance has recently emerged twice before the courts. It would be better to consider the judicial attitudes towards the question before discussing it academically.

---

before termination of the contract has taken effect, the insurer shall be liable to provide only such cover as is in accordance with the ratio between the premium paid and the premium that the policyholder should have paid if he had declared the risk correctly."

[225] Law Com No.104 (1980), 4.4-4.17. For example, the proportionality principle gives no guidance as to the situations where the insurer might have reacted to the undisclosed facts other than by an increase in premium, in particular, where the insurer might choose to decline the risk altogether.

[226] *Ibid.*, 4.98-4.108

[227] *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co.Ltd* [1995] 1 AC 501

[228] The Law Commissions Consultation Paper No.182 (2007)

[229] *Ibid*, 4.177-4.182

(i) ***Brotherton v Aseguradora Colseguros***[230]

[4.124] Brotherton reinsured Colseguros' liability as insurers of a Colombian bank against, amongst other things, losses caused by the dishonest or fraudulent acts of the bank's employees. Shortly beforehand, allegations of serious impropriety against the president of the bank were made in the Colombian media concerning irregular loans to connected persons and companies.

The reinsurers sought to avoid the reinsurance contract, claiming that the insurers had been aware of these matters when the cover was placed but had failed to disclose them. At the time of placement, the insurers had no way of knowing that the allegations were untrue. They were, however, clearly material, not only because they constituted circumstances that might give rise to claims under the reinsurance policies, but also because they suggested moral hazard.

The insurers argued that almost all the investigations had been concluded in the bank president's favour. Since the allegations had proved to be unfounded, however, they could not be material.

Insurers also tried to argue that, since the reinsurers had not suffered any actual prejudice as a result of the non-disclosure, they should not be entitled to avoid. Since there had not, in fact, been any actual misconduct, the reinsurers had suffered no harm. If they had known the true situation (not only as to the allegations but also that they were unfounded), they would have written the cover on the same terms as they (in ignorance) did.

[4.125] The Court of Appeal held in the first place that allegations of misconduct which may not in fact have been substantiated have to be disclosed by the would-be insured. In addition, the possibility to vest in the courts discretion to disallow an opportunistic or otherwise apparently unfair resort to avoidance by an insurer was rejected by the Court of Appeal as well. It was held by Buxton LJ that there is no authority for the argument that the court retains a power of equitable intervention to

[230] [2003] EWCA Civ.705; [2003] 2 C.L.C. 629

control its use retrospectively. The learned judge briefly summarized the current positions of law as follows:[231]

(A) The right to rescind depends not on any implied term of the contract but arises by reason of the jurisdiction originally exercised by the courts of equity to prevent imposition, in other words, the right to rescind was based not on an undertaking by the *parties,* but on the recognition by the court of the effectiveness of an act of rescission.

(B) The comment made by Lord Mustill in *Pan Atlantic*, which was relied upon in the argument of insurers in question, that "it would be unjust to enable an underwriter to escape liability when he has suffered no harm", was not addressing that the question of whether, if a material representation has induced the making of the contract, the power of the representee to rescind could be controlled, and the act of rescission could be reversed by the court on the ground that, although the representor could not show the representation to be true at the time of rescission, he can do so by the time of the trial; his Lordship was simply considering whether a representation could be material for the purposes of the Marine Insurance Act 1906 when it had not induced the making of the contract.

(C) It is argued that insurance contract is a special case, being based on utmost good faith in both directions. If it shows mala fides on the part of the insurer to stand on a rescission when he knows that the facts on the basis of which he rescinds are been untrue, the court should find some means to deprive the insurer of the fruits of that act on his part. But this argument does not circumvent the difficulties arising from the self-help nature of rescission,[232] because once it is accepted that the insurer

---

[231] *Ibid*, [46]-[48]

[232] The self-help nature of recession was abundantly explained by Lord Atkinson in *Abram Steamship Co Ltd v Westville Shipping Co Ltd* [1923] AC 773, 781: "Where one party to a contract expresses by word or act in an unequivocal manner that by reason of fraud or essential error of a material kind inducing him to enter into the contract he has resolved to rescind it, and refuses to be bound by it, the expression of his election, if justified by the facts, terminates the contract, puts the parties in *statu quo ante* and restores things, as between them, to the position in which they stood before the contract was entered into. It may be that the facts impose upon the party desiring to rescind the duty of making *restitutio in integrum*. If so, he must discharge that

is entitled to rescind the contract once he has learned of the undisclosed allegation or rumour, then in resisting claims on the basis that the contract no longer exists he is doing no more than standing on his rights in law. Crucially, this means rescission does not depend upon the exercise of judicial discretion. The court does not effect the insurer's election to rescind but simply confirms that the election is effective if conditions for the exercise of the power are satisfied.

However, a differently constituted Court of Appeal suggested that this issue was still an open one, as demonstrated by the following case.

(ii) *Drake Insurance Plc (in Provisional liquidation) v Provident Insurance Plc*[233]

[4.126] A car drove by Mrs. Kaur was involved in an accident with a motorcycle. The motorcyclist was seriously injured and claimed compensation. The car belonged to Mrs. Kaur's husband, Dr. Singh. Mrs. Kaur was insured under her own motor policy by Drake Insurance against liability to third parties when driving another vehicle with permission of the owner, and she also was a named driver under her husband's motor policy with Provident Insurance. Dr.Singh claimed under his Provident Policy, but Provident avoided the policy for non-disclosure. Mrs. Kaur made a claim under her own policy with Drake, who paid the claim in full. The proceedings, brought by Drake against Provident, were for a contribution. Drake claimed, *inter alia*, that Provident had no right to avoid policy.

When Dr.Singh first took out the Provident Cover in 1995, he named Mrs Kaur as an additional driver and disclosed the fact that she had been involved in a "fault" accident in 1994, but later the claim for "fault accident" had been settled by the third

---

duty before the rescission is, in effect, accomplished; but if the other party to the contract questions the right of the first to rescind, thus obliging the latter to bring an action at law to enforce the right he has secured for himself by his election, and the latter gets a verdict, it is an entire mistake to suppose that it is this verdict which by itself terminates the contract and restores the antecedent status. The verdict is merely the judicial determination of the fact that the expression by the plaintiff of his election to rescind was justified, was effective, and put an end to the contract."

[233] [2004] 1 Lloyd's Rep.268 (CA)

party in Mrs. Kaur's favour, at which point it would be recorded as a "no fault" accident. It was found later that Dr.Singh had failed to disclose a speeding conviction at the time of last renewal in 1996, nor did he mention that Mrs. Kaur's 1994 accident had been settled. If Dr Singh had disclosed his speeding offence, he would have had to pay an extra 25% in premium for renewal. However, had Provident also been told that the 1994 claim had been settled and was a no fault accident, Dr Singh's non-disclosure would have make no difference to the premium.

There was no dispute that the speeding conviction was a material fact, but the Court of Appeal held that Provident failed to show it was actually induced by the non-disclosure to enter into the policy on the relevant terms and consequently it was not entitled to avoid the policy. Moreover, an interesting question was asked about whether or not an insurer's right to avoid could be limited by the duty of utmost good faith he owes to the insured. All three appeal judges agreed that, if at the time it avoided the policy, Provident had known or had turned to a blind eye to the fact the 1994 accident was a no fault accident, it would have acted in breach of its duty of good faith.

[4.127] Having reviewed a handful of authorities, Rix LJ conducted a tentative and speculative discussion on the issue of using the doctrine of good faith to curtail the right to avoid. His Lordship noticed that "more recently there appears to have been a new realization that in certain respects English insurance law has developed too stringently or at any rate insufficiently flexibly: and leading cases of the last few years have shown the courts to be willing to find means to introduce safeguards and flexibilities which had not been appreciated before".[234] His Lordship was of the opinion that it would be consonant with the authorities that "the doctrine of good faith should be capable of limiting the insurer's right to avoid in circumstances where the remedy, which has been described in recent years as draconian, would operate unfairly" [235]and "It may be necessary to give wider effect to the doctrine of good faith

[234] *Ibid.*, [87]

[235] *Ibid.*

and recognize that its impact may demand that ultimately regard must be had to a concept of proportionality implicit in fair dealing".[236]

On the facts of the case, the Court of Appeal considered whether or not Provident breached its duty by failing to ask for further information on the status of the 1994 accident before it sought to avoid. The details given in the proposal form might have suggested it was likely to be a no fault accident. Rix LJ, however, did not think this was enough to put Provident on notice of the fact and there is no general principle that an insurer seeking to avoid must give the insured an opportunity to address the grounds of avoidance in the first place. Clarke LJ agreed. There had been no breach of Provident's duty of good faith. Pill LJ, however, reached a different conclusion. Provident had quite a lot of information about the 1994 accident at the time of renewal. It knew that the insured vehicle had been struck in the rear and there was nothing to suggest that the usual principle that the other driver was at fault would not apply. Under its system, the fault classification was routinely used until confirmation that the claim was settled had been received. While this was not enough to establish knowledge or "blind eye" knowledge, it gave rise to more than a speculative suspicion that the earlier accident might affect the premium. In his Lordship's view, Provident's failure to make any enquiry of the insured before taking the drastic step of avoiding the policy was a breach of its duty of good faith.

In conclusion, even though two of the three judges found that Provident had not breached its duty of utmost good faith, comments made by all three learned judges demonstrate that the courts should be allowed to exercise judicial discretion upon whether or not avoidance should be disallowed.

(iii) The reasoning supporting judicial discretion to disallow avoidance[237]

[236] *Ibid.*, [89]

[237] The supportive reasonings are mainly proposed by Mr Peter MacDonald Eggers in his leading textbook *Good Faith and Insurance Contracts* and a series of articles he produced. Those reasonings are summarized in this part. The policy concerns resisting the introduction of discretion into business world and the opposing argument will be argued later at [4.154], [4.155]

[4.128] Firstly, in a Scottish case *Spence v Crawford*, Lord Wright highlighted merits of the court's discretion:[238]

> "On the basis that the fraud is established, I think that this is a case where the remedy of rescission, accompanied by *restitutio in intergrum*, is proper to be given. The Principles governing that form of relief are the same in Scotland as in England. The remedy is equitable. Its application is discretionary, and, where the remedy is applied, it must be moulded in accordance with the exigencies of the particular case…in the case of fraud the court will exercise its jurisdiction to the full in order, if possible, to prevent the defendant from enjoying the benefit of his fraud at the expense of the innocent plaintiff."

Lord Wright focused on the discretion to allow avoidance in the cases of fraud, but it is also suggested that even in the certain cases of fraud, discretion to disallow avoidance shall be exercised in order to reach a just result. For example, if an insured has incurred 10 separate instances of insured losses, amounting to £1,000,000, and on the last day of the policy period presents a fraudulent claim in the amount of £10,000, to allow insurer to avoid the insurance contract and recover all the indemnity he has paid in respect of earlier losses would seem disproportionately hard on the insured and accordingly, avoidance shall be disallowed.[239]

[4.129] Secondly, the most important reason given in *Drake Insurance Plc (in Provisional liquidation) v Provident Insurance Plc* in supportive of possibility of an avoidance being disallowed is that avoidance should not be used as "an indispensable shield for underwriter into an engine of oppression against the assured."[240] Indeed, the equity traditionally provides its assistance to prevent a statutory remedy being used as engine of fraud.[241] If the insurer wants to resort to the remedy of avoidance with unclean hands, there is no reason as a matter of principle why the avoidance shall be allowed in such cases.

---

[238] [1939] 3 ALL ER 271, 288-289

[239] Eggers, PM, *Remedies for the failure to observe the utmost good faith* [2003] LMCLQ 249, 267

[240] *Commercial Union Assurance Co. Ltd v The Niger Co.Ltd* (1922) 13 Ll.L.Rep.75, 82(Lord Summer)

[241] *Halsbury's Law of England*, 4th edn (1992), vol.16, at paras.754-755

[4.130] Thirdly, when the famous *Pan Atlantic* reached the Court of Appeal, Sir Donald Nicholls VC expressed his concern on the current unsatisfactory position upon avoidance. He said:[242]

> "The contract of insurance is avoided altogether, or it stands in its entirety. This is not the only field in which English law still seems to adopt a fairly crude, all-or-nothing approach, when what is needed is a more sophisticated remedy more appropriate, and in that sense more proportionate, to the wrong suffered. The introduction of a judicial discretion into this field would not be without its advantages."

His Lordship suggested the introduction of judicial discretion on avoidance should be a policy of "justice and fairness".

[4.131] Fourthly, literally speaking, Section 17 clearly use the word "may" to confer the right of avoidance by the innocent party, which ordinarily indicates discretion on the part of judge or the party who may do whatever it is but is not bound to do so.[243]

[4.132] In conclusion, it is suggested that discretion could be an effective way to control the seemingly limitless use of avoidance in practice.[244] The outcome would be a more proportionate one if the discretion can be exercised. Then the question arises what the court would do if it would like to enjoy this right. Generally, equitable discretion is exercised on wider grounds by taking into account all relevant matters that tend towards the justice or injustice of granting the remedy that is sought, such as hardship, unfairness, the lack of clean hands, and so on, and by weighing them against each other in order to decide whether the relief shall be granted.[245] It has been

---

[242] *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co. Ltd* [1993]1 Lloyd's Rep.496, at 508 (CA)

[243] Bingham, T, *The Rule of Law*, Allen Lane (2010), 52

[244] The criticism from the author against the introduction of discretion is provided below, see [4.155]

[245] Spry, *The Principles of Equitable Remedies*, 4th edn, Sweet&Maxwell (1990), 4

suggested that the following elements, *inter alia*, should be considered when exercising the judicial discretion to override the avoidance of the contract[246] (a) Whether or not the remedy is disproportionate to the nature of the breach and the damage done; (b) The public policy in the deterrence and punishment of fraud; (c) The culpability of the party in breach; (d) The effect of the avoidance on the guilty party; (e)Whether or not the interests of third parties have intervened.

(d) The availability of damages for breach of the post-contractual duty of good faith

[4.133] In *La Banque Financiere de la Cité S.A. v Westgate Insurance Co.Ltd,*[247] an attempt was made to introduce a remedy in damages regarding breach of duty of utmost good faith on the part of insurers. The claimants were a syndicate of banks who lent substantial sums to a businessman, who defaulted on the loans. The banks' main security was a series of credit insurance policies, guaranteeing repayment. The banks' brokers placed the insurance, and the banks were co-insured under the policies but the policies contained fraud exclusion clauses which proved to be useless in that event with the result that the banks were left with large losses. On further investigation, the banks discovered that one of their own broker's employees had also been dishonest. The insurers' agent had discovered this but had failed to mention it to the banks. The banks argued that at the time they were in pre-contractual negotiations with the insurers over further policies. The fact that a fraud had been committed to them was highly relevant to them. If they had known, they would not have made further loans. The failure to disclose, the banks said, was a breach of the insurers' duty of good faith, and the insurers should compensate them for the losses that had resulted.

---

[246] Finn, *Equitable Doctrine and Discretion in Remedies*, in *Restitution-Past, Present and Future-Essays in Honour of Gareth Jones* , Cornish& Nolan& O'Sullivan& Virgo (Ed), Hart Publishing (2000), 273

[247] [1987] 1 Lloyd's Rep.69(High Court); [1988] 2 Lloyd's Rep.513 (Court of Appeal); [1990] 2 Lloyd's Rep.377 (House of Lords)

[4.134] At the first instance, Steyn J thought the question whether an action for damages lies for breach of the obligation of the utmost good faith in an insurance context must be considered from the point of view of legal principle and police. His Lordship also noted that considering the reciprocal nature of the duty, standing in the shoes of insured, the remedy of avoidance and the recovery of premiums in restitution by itself may be a wholly inadequate remedy. He considered this is a novel problem but nevertheless ruled that damages are available for breach of duty of utmost good faith.[248] The Court of Appeal, on the other hand, overruling the decision of Steyn J, declared that avoidance is the only remedy available to the innocent party. Four reasons are given to support the findings: (1) There is no authority, even in any common law court, for the award of damages for the breach of the duty of good faith;[249] (2) Damages will be available only if the duty could be described as contractual, statutory, tortious or fiduciary. The duty of utmost good faith is not a contractual duty, but is imposed by law; The duty is statutory but the statutory provision gives avoidance as the only remedy resulting in the unlikelihood of awarding damages; The duty might be fiduciary in very limited situations but cannot be widely applicable; The duty might be breached as a matter of principle of tort but this is not the situation of the case in question;[250] (3)To award damages for breach might result in hardship, for example, an insured who has in complete innocence failed to disclose a material fact when making an insurance proposal might find himself subsequently with a claim by the insurer for a substantially increased premium by way of damages before any event has occurred which gives rise to a claim;[251] (5) The powers of the courts to grant relief where there has been non-disclosure of material facts in the case of a contract *uberrimae fidei* stems from the jurisdiction originally exercised by the Courts of Equity to prevent imposition. The powers of the courts to grant relief by way of rescission of a contract where there has been undue influence or duress stem from the same jurisdiction. Since duress and

[248] [1987] 1 Lloyd's Rep.69, 96

[249] [1988] 2 Lloyd's Rep.513,546

[250] *Ibid.*, 549

[251] *Ibid.*, 550

undue influence as such give rise to no claim for damages, there is no reason in principle why non-disclosure as such should do so.[252]

The conclusion of the Court of Appeal was accepted by Lord Templeman, who said that: "I agree with the Court of Appeal that a breach of the obligation does not sound in damages. The only remedy open to the insured is to rescind the policy and recover the premium."[253] However, it is noteworthy that this opinion was merely *obiter* of the House.

[4.135] The reasons given by the Court of Appeal are seemingly not overwhelming and are fully argued by Mr. Peter MacDonald Eggers QC in his prominent leading textbook *Good Faith and Insurance Contracts* and some subsequently published articles:[254] (1) The law should be capable of developing. The absence of authority is not the good reason for the refusal of introduction of a new remedy into this area in order to correct the draconian and rigid consequence of breach of utmost good faith; (2) It is submitted that the duty need not be classified as within contractual, statutory, tortious or fiduciary duty to attract the common law remedy of damages. The only thing needs to be asked is whether a duty at law exists and if so whether as a matter of principle and policy damages should be recovered for a failure to observe good faith; (3) The example given by the judge is inappropriate because (a) it is no more harsh than the remedy of avoidance and (b) it only reflect the loss sustained by the innocent party caused by the breach and (c)from the perspective of the insured, it is different to imagine a circumstance where the award of damages will cause more hardship than the lack of remedy at all; (4) It might be inappropriate to attribute duress and undue influence with the characteristics of duty of utmost good faith, because (a) undue influence is purely equitable so damages as common law remedy would certainly not

---

[252] *Ibid.*

[253] [1990] 2 Lloyd's Rep.377, 387

[254] Eggers, PM & Picken, S& Foss, P, *Good Faith and Insurance Contracts*, 3rd edn, Lloyd's List (2010), 16.129-16.135; Eggers, PM, *Remedies for the failure to observe the utmost good faith* [2003] LMCLQ 249, 275-276; Eggers, PM, *Pre-contractual duty of utmost good faith-materiality and remedies*, Chapter 3 of *Marine Insurance: Law in Transition*, Thomas, DR (Ed), LLP (2002)

be applicable and (b) damages are recoverable for duress when duress is such as to amount to tort though damages for duress are not allowed to recover in all cases.

[4.136] The facts of *Banque Financiere* were purely concerned with pre-contractual non-disclosure resulting in the breach of the duty of utmost good faith under Section 17 of the Marine Insurance Act 1906. As the duty under Section 17 is a continuing one, the question which may be validly asked is: will the law be also applicable to a breach of post-contractual duty of utmost good faith, particularly in the context of fraudulent claims? In *The Good Luck*[255], May LJ commented: "Assuming that the obligation can continue, we see no reason why the source in law of obligation, or the remedy for its breach, should be different after the contract is made from what it is at the pre-contractual stage"[256], and then the claim for damages in this case was dismissed again by the learned judge.

[4.137] In conclusion, the law in its present state, short of authorities from the House of Lords, seems certainly and most firmly settled that damage is not available for breach of pre-contractual duty of utmost good faith, but with regard to post-contractual duty of utmost good faith the position is not absolutely beyond dispute. Aikens J in *The Mercandian Continent*[257] carefully and respectfully considered that the remedies for breach of the duty ought not to be so confined only to avoidance, at least at the "post contract" stage. In *Aldrich v Norwich Union*,[258] Mummery LJ was careful to preface his application of *Banque Financiere* with the words "in the absence of fraud". Lord Hobhouse in *The Star Sea* also suggested that: [259] "as will also become apparent from the citation, the content of the obligation to observe good faith has a different application and content in different situations."

---

[255] [1989] 2 Lloyd's Rep.238, CA

[256] *Ibid.*, 263

[257] [2000] 2 Lloyd's Rep.357, [63]

[258] [2000] Lloyd's Rep.IR 1,8

[259] [2001] 1 Lloyd's Rep.389, [48]

[4.138] It is noteworthy that the position that breach of utmost good faith does not sound in damages was accepted by both parties in *The Star Sea*,[260] but this was criticized by Mr. Peter MacDonald Eggers QC as being "difficult to understand". The counsels might just miss the chance to offer the House of Lords to consider this issue again. Nevertheless, entitlement to damages for breach of utmost good faith is in line with the trend that the power and availability of remedy of avoidance shall be restricted.[261] Furthermore, in the light of an increasing change of emphasis from the duty of utmost good faith the insured owes to the insurer to the duty the insurer owes the insured,[262] damages would be in many cases be a more suitable remedy than avoidance. It should be kept in mind that one of the advantages of the common law jurisdiction is its ability to respond to perceived change of social background of law, as Lord Steyn commented that "the enduring strength of the common law is that it has been developed on a case-by-case basis by judges for whom the attainment of practical justice was a major objective of their work. It is still one of the major moulding forces of judicial decision-making".[263] In 2010, the Law Commissions published an issues paper on *Damages for Late Payment and the Insurer's Duty of Good Faith*.[264] In the context of the insurer's breach of the duty of good faith, the Law Commissions thought that legislation should set out appropriate remedies for the insurer's breach of the duty of good faith, which should include damages for foreseeable losses.[265] They proposed that where the insurer is dishonest or guilty of maladministration beyond everyday error when dealing with the insured's claim, for example, the insurer does not investigate claims fairly, or he does not assess claims in a way which is free from bias, or he considers a claim to be invalid but does not give the insured reasons for his decisions, or he considers the claim to be valid but does not pay it within a reasonable time, the insured would be able to recover losses for breach of contract where such losses are foreseeable on the normal *Hadley v Baxendale*

[260] *Ibid.*, [49]

[261] *The Mercandian Continent* [2001] 2 Lloyd's Rep.563

[262] *Drake Insurance Plc (in Provisional liquidation) v Provident Insurance Plc* [2004] 1 Lloyd's Rep.268 (CA)

[263] *Attorney General v Blake* [2001] 1 AC 268, 292

[264] http://lawcommission.justice.gov.uk/docs/ICL6_Damages_for_Late_Payment.pdf, accessed on 4th April 2012

[265] *Ibid.*, 9.26

principles, either the losses may fairly and reasonably be considered as arising naturally; or they arise from special circumstances communicated at the time the contract is made.[266] It is also noteworthy that the Law Commissions agreed that the law is right to recognize mutual duties to act in good faith in insurance contract.[267]If this is the case, there would be no firm reasons why breach of the insurer's post-contractual duty of good faith could result in damages but breach of the insured's post-contractual duty of good faith could not.

[4.139] In theory, fraud may constitute tort of deceit and the fraudster may be liable to damages if the following three requirements are established:[268]

> "(1) A person may be liable for deceit, not only if he makes a representation which is false when made, but also if he fails to correct a representation which has, to his knowledge, been falsified by events; (2) The misrepresentation may be made knowingly, or recklessly, that is, careless whether it is true or false; and misrepresentation must be made with the intention that it should be acted upon by the representee, or by a class of persons which includes the representee, in the manner which resulted in damage to him; (3) The representee must have acted upon the false statement, and suffered damage by so doing."

The first two conditions are in accordance with the general meaning of fraud which has to be established before the insurer may invoke the proper remedies.[269] However, in the context of fraudulent insurance claims, inducement does not need to be proved [270] and accordingly, there is not much room for claiming damages by way of the tort of deceit.

---

[266] *Ibid.*, 9.24, 9.27, 9.36

[267] *Ibid.*, 9.10

[268] *Twinsectra Ltd v Yardley* [1999] Lloyd's Rep. Bank 438, 447

[269] See Chapter One

[270] See Chapter Two, at [2.19] and [2.28]

V. The Summary of Current Legal Status

[4.140] After a long analytical journey, it might be appropriate to summarize the current ambit of fraudulent claim jurisdiction as follows:

A. There are four distinct approaches dealing with fraudulent claims as far as it may concern currently: (1) the express contractual provisions; (2) the common law rule of forfeiture; (3) the implied contractual analysis; and (4) the post-contractual utmost good faith.

B. As a matter of certainty, the insurers are always encouraged to put a properly drafted fraudulent claim clause into the insurance contract, stipulating, for example, that it is a condition precedent to liability that any claim be advanced in good faith and not fraudulently. This approach is considered as "the best practical solution".[271] Any argument arising out of the clause would ultimately be the issue of interpretation towards the meaning of the clause in question.

C. In the absence of express provisions, all the insurance contract ought to contain an implied term requiring the insured not to submit fraudulent claims. This implied term should be categorized as a condition in the insurance contract, the breach of which will entitle the innocent insurer to terminate the contract, if he chooses, and claim damages such as investigation costs.

D. The effect of common law rule of forfeiture is that the particular claim tainted by the fraud could be wholly rejected and any interim payment made to this claim could be recovered back. However, the separate clean claims would be uninfluenced.

---

[271]Mance & Goldrein, I & Merkin, R (Ed), *Insurance Disputes*, 3rd edn, Informa (2011), 4.165

E. The doctrine of the duty of utmost good faith continues after the inception of insurance contract, and it is suggested that it shall govern the presentation of claim as well, at least it requires the insured not to be fraudulent in submitting the claim. This requirement can be justified as a matter of social and economic policies and it may well serve the function of deterrence and punishment of fraud. The current position of law, particular the law in relation to the remedies for breach of duty, namely avoidance *ab initio*, is indeed not satisfactory, but this is not the simply reason to exclude the making of fraudulent claim from the ambit of the continuing duty of utmost good faith, because as the most clear-cut situation of bad faith, it would be conceptually at odds and hard to justify this exclusion. The appropriate reform shall start from re-considering the following suggestions: (1) the remedy of avoidance *ab initio* might be restricted conditionally in the post-contractual circumstances; (2) the court should be granted the discretion to disallow the avoidance in certain circumstance; and (3) the damages is suggested to be the alternative remedy for breach of the doctrine of utmost good faith, at least in the post-contractual context.

F. The life might be easier for the insurer if there is an express provision in the contract prohibiting fraudulent claims, but it might be harder in the absence of express terms. The relationship between the other three approaches needs to be clarified:(a)The origins for these three approaches are completely distinct with each other: the implied contractual analysis speaks for itself; the common law rule of forfeiture is a matter of public policy; and the doctrine of utmost good faith derives directly from the requirement of law. There is no internal and essential conflict with these approaches; (b) The special common law defence may be invoked together with the implied contractual defence, so the insurer would be entitled not only to reject the entire fraudulent claim but also to terminate the insurance contract prospectively and claim damages if there is any; (c) Currently, the court tend not to use the post-contractual duty of utmost good faith as a judicial basis for determine the remedy of presentation of fraudulent claims due to the harshness of the remedies.

VI. The Policy Evaluations Regarding the Selection of Appropriate Remedies

[4.141] The previous discussions have revealed that in numerous respects the law regarding the remedies available for the presentation of fraudulent claim is not settled. In such circumstances, taking into account both interests of insured and insurer, the law should be developed to provide a relatively firm answer required to make the situation fair and just. Before considering the proposed restatement, it may be helpful to reconsider some concepts, notions and policy concerns that are currently accepted.

A. The demand for various liability regimes: the conflict between certainty and flexibility

[4.142] Tracing back to 18th century, certainty as an important value of commercial law has been well recognized by the court in UK. In *Lockyer v Offley* Willes J stated that:[272]

> "As in all commercial transactions the great object is certainty, it will be necessary for this Court to lay down some rule, and it is of more consequence that the rule should be certain, than whether it is established one way or the other."

In addition, Lord Bingham, the former Senior Law Lord, the most eminent of our judges, clearly stressed the value of certainty at the start of his judgement in *The Golden Victory*[273] by saying that:

> "The quality of certainty [is] a traditional strength and major selling point of English commercial law"

[4.143] There ought to be no doubt, in principle, on this point. A legal rule devoid of certainty and predictability would lack of cohesion and continuity. In entering into

[272] (1776) 1 T.R.252, 259

[273] *Golden Straight Corporation v Nippon YKK* (The Golden Victory) [2007] UKHL 12, [1]. Although Lord Bingham was in the minority of this judgement, it does not affect the correctness of this proposition.

agreements or consummating other transactions, commercial people could never be sure whether the law of yesterday would still be the law of tomorrow. "Law as a guide to conduct is reduced to the level of mere futility if it is unknown and unknowable."[274]

[4.144] However, in the middle of 20th century, particularly since the Court of Appeal delivered the judgement in *The Hongkong Fir*[275] case, the courts have engaged themselves in a serial of cases regarding the choice of certainty and flexibility. In slow stages the flexible approach allowing the courts to look at the effect of the breach rather than the nature of terms in question seemingly has taken over the popular position. Lately, however, the judicial attitude appeared to swing back to the need of certainty. Firstly, in *The Mihalis Angelos*,[276] the charterparty in question contained a clause stating that "the vessel is expected ready to load about 1st July 1965". When giving this expected ready to load date, the shipowner had no reasonable grounds about it. It was found later that the vessel could not arrive at the loading port on 1st July 1965. The charterer wanted to cancel the charterparty on the ground that the expected ready to load date clause is a condition. The Court of Appeal held that the clause is a condition for "four inter-related reasons", but the first and foremost reason is it tended towards certainty in the law: [277]

> "One of the important elements of the law is predictability. At any rate in commercial law, there are obvious and substantial advantages in having, where possible, a firm and definite rule for a particular class of legal relationship...Where justice does not require greater flexibility, there is everything to be said for, and nothing against, a degree of certainty in legal principle."

Then the House of Lords expressed their points of view in *Bunge Corporation New York v Tradax Export SA*[278], stressing again that certainty is "the most indispensable quality of mercantile contracts".[279]

---

[274] Cardozo, *The Growth of the Law*, New Haven (1924), 3.

[275] *Hongkong Fir Shipping Ltd. v. Kawasaki Kisen Kaisha Ltd* [1961] 2 Lloyd's Rep.478

[276] [1970] 2 Lloyd's Rep.43

[277] *Ibid.*, 55

[278] [1981] 2 Lloyd's Rep.1

[4.145] Although the above argument focused upon identifying the nature of the relevant provisions in the commercial contract, the principle can be applied in the discussion of remedies available for the presentation of fraudulent claims in commercial insurance contract. From the perspective of insured, a certain and predictable remedy available to the insurer can function as a deterrence of fraud: insured will know that he cannot submit fraudulent claims, otherwise he will be punished accordingly. From the perspective of insurer, a certain and predictable remedy will make him respond to the fraud rapidly and appropriately, therefore protecting his rights in a proper way.

[4.146] However, the current legal position, as discussed earlier, proves to be quite uncertain. While it is universally accepted that the insured must not make a fraudulent claim, there is as yet little consensus as to why this is the case. This is significant in that the remedies for breach of duty vary, depending upon the duty broken. The possibilities are divided into three general categories:

a) breach of common law rule
b) breach of contract terms
c) breach of the duty of good faith

The range of consequences is:

a) The claim is lost in its entirety without effect on the policy
b) The policy terminates as of the date of the fraud
c) The insurers have an option to refuse to pay without determining the entire policy
d) The policy is voidable *ab initio*
e) The insurers have the option of refusing to pay without avoiding the policy *ab initio*

[4.147] An express term can stipulate for any of these. If the insurer chooses to rely on breach of implied terms, the choice is between a) and c). If the basis is utmost good faith, the choice is between d) and e). It can be seen that the range of remedies is

[279] *Ibid.*, 5 (Lord Wilberforce)

quite different and the insurers might get confused when they evaluate the claim: what remedies can they invoke? Thus, the question becomes: is it really necessary to develop two branches of remedies: one on the basis of common rule and contractual principles and the other on the ground of the duty of good faith?

[4.148] The branches could be reconciled if it is recognized that the post-contractual duty of good faith operating as an implied term of the contract, breach of which would then give rise to remedies under normal contract principles. However, while the notion of good faith may be an underlying value to decide whether or not to imply relevant terms such as cooperation terms into contract, the duty of good faith itself cannot be simply categorized as an implied term in the contract.

[4.149] First of all, the recognition of an implied doctrine of good faith would generate great uncertainty. In *Walford v Miles*,[280] at an advanced stage of the negotiations the defendants orally agreed to terminate negotiations with any other potential purchasers and not to accept any other offers if the plaintiffs provided a letter of comfort from their bankers confirming that they had finance available to complete the purchase. The plaintiffs did provide the letter and the defendants broke off negotiations with other potential purchasers, but a few days later they decided not to pursue the negotiations with the plaintiffs and sold the business to a third party. The plaintiffs brought proceedings in which they alleged, *inter alia,* that it was an implied term of the contract that so long as the defendants wished to sell the business they would continue to negotiate in good faith with the plaintiffs. They said that the defendants' breach of contract had deprived them of the opportunity of completing the purchase and that they had lost the difference between the price they had agreed to pay for the business and its (higher) market value. The House of Lords held that the concept of a duty to carry on negotiations in good faith is inherently repugnant to the adversarial ethic underpinning English contract law and an implied obligation to negotiate in good faith is not valid. The conclusion that English Law does not recognize the validity of a implied duty to carry on negotiations in good faith makes it

---

[280] [1992] 2 AC 128

very difficult, if not impossible, for a court to recognize the existence of implied doctrine of good faith in English contract law. Lord Bingham recognized that good faith is an objective criterion which imports the notion of fair and open dealing, but there is no common concept of fairness or good faith.[281] Good faith presupposes a set of moral standards and restrictions on the pursuit of self-interest but it is not clear how far these restrictions go, endless questions might be asked: e.g. whether a requirement of good faith adds anything to the regulation of bad faith; whether good faith imposes both negative and positive requirement namely non-opportunism, non-shirking as well as positive cooperation, support, and assistance. English lawyers tend to be hostile to broad, general principles. They are much more comfortable when individual rules could be invoked.[282] Accordingly, while it is possible to validate an express term of a contract which employs the language of good faith based upon the concept of freedom of contract,[283] and it is possible to imply a duty not to submit fraudulent claims in insurance contract, it would not be right to categorize a duty to act in good faith as an implied contract term.

[4.150] Secondly, because English Law permits the parties to exclude liability for both deliberate acts and negligence despite such clauses would be construed narrowly, it is possible that the parties are free to exclude implied terms of good faith by express agreement. However, if this is true, it would be fundamentally contradictory to the idea that insurance contract being based upon good faith.

[4.151] To sum up, the suggestion that the post-contractual duty of good faith operating as an implied term of the contract must be rejected. The right approach is to treat the nature of the post-contractual duty of good faith as the same as the pre-contractual one, which means it is a separate rule of law and it is a statutory duty.

---

[281] See *Director General of Fair Trading v First National Bank* [2001] 1 AC 481, [36]

[282] See McKendrick, E, *Good Faith: A Matter of Principle?* in Forte, A, (Ed), *Good Faith in Contract and Property Law*, Hart Publishing (1999), 39

[283] *Petromec Inc v Petroleo Brasileiro SA Petrobas* [2006] 1 Lloyd's Rep.121, [121] (Longmore LJ)

[4.151] In order to make the law easy to operate and predict, it would be better if only one branch of remedy is adopted. The question would then be: will this adoption certain enough to constitute good law? It shall be borne in mind that certainty and predictability alone, however, are not sufficient to provide an effective, vital system of law to commercial world. In a fluid world, law cannot function effectively if it is conceived solely as an instrument of permanence, as Lord Roskill said in an address as President of Birmingham University Law Faculty's Holdsworth Club in 1981:[284]

> "Everyone who has a part, large or small, to play in the evolution of commercial law must surely always have regard to two principles as paramount. First, that law should be certain. Secondly, whilst being certain, it must be adaptable to the changing needs of the particular period. Those two principles are not contradictory. On the contrary, they are complementary."

[4.152] An absolute doctrinal certainty is not good as it would make the law rigid and inflexible; A good law, being certain and predicable, shall also be intelligently capable of responding to new developments in commercial practice or the facts of particular cases. Adoption of one and abandon the other does not mean the law in the regard is rigid and inflexible. Either of the branches-the contractual method or the duty of good faith-could be developed on its own to respond different situations depending upon the degree of turpitude involved. On the one hand, the law may slowly creep to the position that there is an implied contractual right arising out of the law of contract which permits insurers reject the claim and/or prospectively terminate the policy and in addition to seek damages for breach of contract by the insured; on the other hand, the law may reach the conclusion that submission of fraudulent claims is a breach of the duty of good faith, so the insurers may be able to avoid that contract *ab initio*, however, depending upon the spectrum of culpability, the courts may exercise discretion, disallow the avoidance remedy but instead award the damages only.

Since it may not be able to reconcile two different approaches, the next question would be: which one is to be preferred?

[284] (1982) 7 Hold L.R., 2-3

B. Reconsideration of the principle of good faith in post-contractual context

[4.153] Presumably, one of the original purposes of the observing the duty of good faith is to correct the imbalance in the knowledge of the each of the parties to the contract and this imbalance exists in the case of presentation of claims. This means, usually, the insurers have to rely on documents, information and representations provided by the insured in order to determine whether a loss is payable or not and if so in what amount. It shall be noted that during Lord Mansfield's period, in which the duty of utmost good faith was established and developed, the tools of communication were poor, as well as the state of forensic investigation. By contrast, there are today a handful of investigation techniques and information management solutions that permit the insurers to investigate claims and reveal the inside of the stories and get to the bottom of the truth.[285] For instance, for the moment on losses of marine vessels, can it really be held that insurers today place much reliance at all on the documents and information provided by the insured? In the case of sinking of the vessel, how often can it truly be said that the underwriters simply stay calm, safe and wait for the documents and information to be provided by the insured in presentation of a claim? In practice, this must be very rare. When the sinking, grounding and fires occur, the insurers will usually instruct their solicitors and loss adjusters immediately who go straight to the scene of casualty, arrange interviews, take joint statements from the crews and master of the vessel, and have immediate access to all the ship's documents. Where the insurers are so assertive, it may be said that they are hardly relying on information from the insured at all. If so, perhaps it would not be surprising that the insurers shall not be allowed to invoke the defence of utmost good faith. This is even the case at the pre-contractual stage, where the insurers choose not to take a passive role in assessing the insured risk by receiving the information provided by the insured but choose to take an active action in inquiring into the specific features of the proposed risk or in ascertaining the material facts, there is less need for a duty of disclosure at least in respect of the aspects of risk which the insurers choose to look into.

[285] The importance of investigation is discussed in details from the perspective of economics in Chapter Five, below, at [5.15]-[5.21]

[4.154] In addition, the above analysis regarding restrictions on the remedy of avoidance has demonstrated that a comprehensive judicial or legislative reform has to be performed if this area of law is going to be adopted. The question that needs to be asked is: does this reform really necessary? It shall be borne in mind that reform is a painful step because it will inevitably jeopardize the certainty and stability of the law.

In the first place, any reform shall proceed in a meticulous way, as it was warned by Viscount Simonds in *Midland Silicone Ltd v Scrttons Ltd* that:[286]

> "...heterodoxy, or, as some might say, heresy, is not the more attractive because it is dignified by the name of reform. Nor will I easily be led by an undiscerning zeal for some abstract kind of justice to ignore our first duty, which is to administer justice according to law, the law which is established for us by Act of Parliament or the binding authority of precedent. The law is developed by the application of old principles to new circumstances. Therein lies its genius."

Reading between the lines of this speech, his Lordship seems to suggest that if the application of old principles to new circumstance could work well, there is no need to disturb the certainty of law in the name of reform. The experience that comes from practice through a long period of history cannot be ignored. If this understanding is correct, it is suggested that using the principle of utmost good faith into post-contractual context by way of substantial reform exerting on the principle itself may not be necessary. To begin with, despite the fact that insurance is *uberrimae fidei*, the principle of utmost good faith is no omnipotence and indeed need not to be. The essence of the relationship between insured and insurer is contractual, and in the light of the analysis provided above, contractual approach (express or implied), without being modified substantially, is capable of tackling the problem of fraudulent claims. Secondly, the common law rule of forfeiture, being a long existed remedy provided by the court and applied in the modern context, has found its new life and been proved to be feasible and capable of producing equity and justice. If the problem can be solved within the contractual context by using the old principles, why bother to disturb the current propositions and radically reform the law? It shall be remembered

[286] [1962] AC 446, 467-468

that this kind of reform may not be a proper task of the courts of law but of Parliament and it may produce a lot of unnecessary high legislative cost.[287]

[4.155] In addition, the essence of reform proposed above is that remedy of avoidance should be flexible and discretional, and should not be an "all or nothing" approach. However, there is an important policy disagreement with this discretional approach, which is proposed by Lord Bingham in his prominent book *The Rule of Law*, where his Lordship suggests it is one of the requirement of the rule of law that: [288]

> "Questions of legal right and liability should ordinarily be resolved by application of the law and not the exercise of discretion."

Although this proposition does not mean that there should be no discretion at all, it certainly makes it clear that discretion is not ordinary and should be constrained and should not "be legally unfettered".[289] It is suggest that "precedent, consistency, analogy and above all an appreciation of the limits of the judicial as opposed to the legislative role" [290]should all serve the purpose of controls and restraints. If applying those restrictions to the suggested discretional avoidance remedy, it may be concluded, possibly surprisingly, that avoidance may not be able to bear the discretion ingredient at all. First of all, it should be noted that the remedy of avoidance was discussed in the context of insurance in a common law case *Carter v Boehm* with a common law judge Lord Mansfield sitting in King's Bench, therefore, it is doubtful that avoidance, in the view of judicial history, should be categorized as an equitable remedy. Secondly, it should also be noted that the major supportive argument for discretion comes from the case of *Drake Insurance Plc (in Provisional liquidation) v Provident Insurance Plc*,[291] but it can hardly be held that this case is in essence dealing with the insured's post-contractual duty of good faith. Mr Peter MacDonald Egger's arguments are actually

[287] See the economic analysis conducted in Chapter Five, at [5.28]

[288] Bingham, T, *The Rule of Law*, Allen Lane (2010), 48

[289] *Ibid.*, 54

[290] Lord Mance, *Should the Law be certain?* The Oxford Shrieval lecture, 11th October 2011, http://www.supremecourt.gov.uk/docs/speech_111011.pdf, accessed on 4th April 2012

[291] [2004] 1 Lloyd's Rep.268 (CA)

established very much on a few *obiters* delivered by Rix LJ in passing lines, the foundations of which may, therefore, not be as stable as it looks like at the first sight. Thirdly, the judicial adoption of the post-contractual duty of good faith as the remedy against fraudulent claims will have to be inconsistent with some justified precedents given by the House of Lords/Supreme Court and the Court of Appeal, the judicial role of the court may accordingly be expanded inappropriately.[292] Fourthly, in Section 2 (2) of Misrepresentation Act 1967, it is submitted discretional avoidance is only available to the situation "where a person has entered into a contract after a misrepresentation has been made to him otherwise than fraudulently". The Section may impliedly indicate that the courts are not allowed to refuse avoidance and award damages in lieu in fraudulent misrepresentation cases because, in the light of public policy, the defences available to the fraudsters should be limited; the fraudsters should not be easily allowed to escape the consequences of their fraudulent act.[293] There seems no firm ground not to apply this reasoning into the fraudulent claims cases. In addition, the self-help nature of avoidance may particularly be justified in fraud cases because "the defendant's conduct is particularly bad" and it calls for this mechanism of avoidance without the need for avoidance to be effected by the court.[294] Fifthly, even if discretional avoidance is allowed, it seems that it will be functional properly only if it works with the right of the court to award damages in the case of breach. However, it has been concluded that the suggestion of the post-contractual duty of good faith operating as an implied term of the contract must be rejected, which makes the foundation of awarding damages very weak[295] and accordingly, unless Section 17 is legislatively rewrote, discretional avoidance alone, without the supplementary help of

---

[292] Although in Practice Statement (Judicial Precedent) [1966] 1 WLR 1234, the House of Lords announced that "it would depart from a previous decision when it appeared right to do so", the power has to be exercise "rarely and sparingly".

[293] Cartwright, J, *Misrepresentation, Mistake and Non-disclosure*, 3rd edn, Sweet&Maxwell (2012), 4-62 and 5-29.

[294] O'Sullivan, D& Ellliott,S& Zakrzewski, R, *The Law of Rescission*, Oxford (2008), 250; Andrews, N & Clarke, M &Tettenborn, A &Virgo, G, *Contractual Duties: Performance, Breach, Termination and Remedy*, Sweet&Maxwell (2012), 1-029

[295] It should be clearly noted that Section 17 of Marine Insurance Act 1906 does not on its face leave scope for any other remedy that avoidance of the contract. Mance, *The 1906 Act, common law and contract clauses-all in harmony?* [2011] LMCLQ 346, 354

damages, may not be able to serve the purpose that it should have been in the blueprint.

[4.156] Finally, it is submitted that the adoption of the duty of good faith in post-contractual context with the draconian remedy of avoidance is for the purpose of punishing the fraud. However, the suggest may be contradictory to the underlying principle that the business of civil law including commercial law is "to adjudicate on disputes between private citizens (including, of course, companies) as to their respective rights and liabilities or on disputes between private citizens and the executive as to the legality of the executive's actions or omissions".[296] In other words, punishment seems to be the function of criminal law, but insurance is governed by the private law and the mutual rights of the parties are creatures of contract.[297] So a further question needs to be asked is: if the normal contractual principle-repudiation and award of damages-could work properly in this context, is the adoption of the duty of good faith still necessary?

[4.157] The presumed argument here that the criminal law seeks to punish and the civil law to compensation is perhaps too rigid. To strictly insist on such classification in every instance is to ignore the overlap between the idea of crime and that of a mere breach of a civil obligation. A flexible device to administer justice by the most appropriate measure for both compensation and punishment will probably be required to bridge the gap between the traditional divisions of law. It shall be borne in mind that the commitment of commercial fraud is not irrationally motivated but stands for a clear manipulation of a complicated network, and a person who commits insurance fraud is capable of rational reasoning and works out his "trade-offs". He is likely to be guided by the likelihood of his gains and the efficiency with which the fraud could be committed, and if the returns are sufficiently high, he may nevertheless justify the perpetrations. Punishment may be an anomaly in civil law context, but if it could serve a useful purpose and make the fraudsters pay, it may nevertheless be adopted.

---

[296] Scott, *Damages*, [2007] LMCLQ 465, 469

[297] Mustill, *Fault and Marine Losses*, [1988] LMCLQ 310, 319

Therefore, a further question is: if the duty of good faith with avoidance as a remedy is not adopted, are the contractual approaches strict enough to serve the strategy of making the price of crime prohibitive?

[4.158] It should be clarified in the first place that the contractual approach in this context includes not only discharge from the contract but also the rejection of the particular claim. The argument placed here is the rejection of particular claim arising out of the special common law is very strict compared with the normal civil law approach and may serve a useful purpose of making fraudsters pay.

[4.159] It has been summarized earlier that the fraudulent part of a insurance claim taints the whole claim and the insurers have the right to reject the claim as a whole regardless of the existence of the good part of claim. Reference should be made to the normal approach regarding the civil fraudulent claim, particularly the cases in which fraudulent devices are used or claim is exaggerated, which may suggest otherwise.

The first illustration is one of the series cases following the sink of the oil tanker THE BRAER resulting in the splitting of oil. In this case, a group of companies asserted that it had suffered loss in its fish farming operations because of an exclusion zone set up following the pollution. The group of companies put forward documentation seeking to demonstrate that the agreements had been made between them and produced falsified letters purporting to be evidence of these contracts. In the court proceedings, the learned judge concluded that the letters had indeed been falsified and witnesses representing the claimant had given false evidence and indeed had been involved in a fraudulent scheme in the presentation of the claim. Nevertheless the civil claim was allowed to proceed on the basis that there were in fact no legally binding contracts but the claimant had still genuinely lost the opportunity to make a profit by rearing salmon off Shetland.[298]

---

[298] Clift, R, *Fraud: Does the punishment fit the crime?* Speech at International Marine Claim Conference (IMCC), Dublin, 2007, http://www.marineclaimsconference.com/2007/index.html, accessed on 4th April 2012

The second example is a road accident case of *Shah v Ul-Haq*.[299] The claimants genuinely produced the evidence proving their injuries in the accident, but fraudulently forged the evidence showing that there was a third person (their mother) in the car at the time of accident and she was also injured in the accident. There were three claims as a whole in this case: two claims from Mr Ul-Haq and his wife and one claim from his mother-in-law. The defendant asked the court to strike out the whole claim under CPR 3.4 (2) on the basis of fraud, but the Court of Appeal clearly held that there was no general rule of law or any reported case whereby a whole claim (in this particular case, the claim in tort) could be dismissed because it had been dishonestly exaggerated. The invariable rule in the normal civil cases is that the judge awards the limited damages which are appropriated to his findings.[300]

The third example is an arbitration case. In *Chantiers De L'Atlantique SA v Gaztransport & Technigaz SAS*,[301] the High Court clearly held that even though one party committed fraud during the arbitration, the award will not be set aside automatically. If the outcome is in all probability unaffected by the fraudulent conduct of that party, then the award may be allowed to stand. Insurance case clearly is not the same treatment. Even if the insurer's ultimate liability will be unaffected by the fraudulent devices or means of insured, the whole claim will nevertheless be rejected.

It may be concluded that the presentation of a fraudulent claim in civil law e.g. in tort or contract will not necessarily deprive the claimant of all the benefit of a genuine claim unless the claimant pursued in such a way as to make a fair trial impossible.[302] It may also be concluded that compared to the approach of civil law against the fraudulent claims, the approach adopted by insurance law seems strict and draconian, particularly in the situation where fraudulent devices are used to support a genuine

[299] [2009] EWCA Civ.542

[300] *Ibid.*, [17]. At [21] Smith LJ was of the further opinion that the policy in civil law may be wrong and the law should be changed. But such change would have to be a matter for Parliament. It should also be noted that in a very recent case *Fairclough Homes Limited v Summers* [2012] UKSC 26, the Supreme Court has decided that, the entirety of a personal injury claim including the honest part will only be struck out if this is a proportionate means of achieving the aim of controlling the process of the court and dealing with cases justly.

[301] [2011] EWHC 3383 (Comm)

[302] *Arrow Nominees Inc v Blackledge* [2000] 2 BCLC 167, [54] (Chadwick LJ)

claim and where the claim is inflated, as Mance LJ admitted that the rule is "deliberately designed to operate in a draconian and deterrent fashion".[303]

Conclusions

[4.160] All in all, this thesis suggests that reform be required: the law needs to be changed in appropriate circumstance, but the step shall move meticulously within the established legal principles.[304] In the light of this guideline, the brief conclusions as to legal analysis on the remedy of presentation of fraudulent claims are provided as follows:

- Currently, there are two branches of remedies available
- Conceptually, it seems that the post-contractual duty of good faith is a proper judicial basis to set up the remedies against fraudulent claims as fraud is exactly the opposite of good faith. However, it is submitted that the current remedy avoidance is not capable of being an appropriate remedy[305] and in addition, the reform on the remedy brings a lot of judicial and legislative

[303] *Axa General Insurance Ltd v Gottlieb* [2005] 1 Lloyd's Rep.IR 369, [31]

[304] This approach was firmly adopted by Lord Wilberforce, "who was one of the most civilised and balanced judges of the 20th century", during his eminent judicial lifetime. See http://www.guardian.co.uk/news/2003/feb/19/guardianobituaries.lords, accessed on 4th April 2012. The author of this dissertation, with great honor and respect, is in full agreement with his Lordship.

[305] Although Professor Yvonne Baatz suggested in her eminent article *Utmost Good Faith in Marine Insurance Contracts*, in Huybrechtes, M(Ed), Hooydonk, EV & Dieryck, C (Co-eds), *Marine Insurance at the turn of the Millennium, Volume 1*, Intersentia (1999), 28, that "the law is and should be that a fraudulent claim avoids the whole policy and not just the claim and only that part of the claim which is fraudulent", her suggestion was established on the case of *Orakpo v Barclays Bank Insurance Service Co Ltd* [1994] CLC 373, which, as it is said by Lord Hobhouse in *The Star Sea* [2001] 1 Lloyd's Rep.389, [66], cannot be regarded as fully authoritative in the view of the contractual approach adopted with regard to whether fraudulent claims can lead to avoidance *ab initio*. Furthermore, her suggestion may also no longer hold true in the light of the judgement delivered by the House of Lords in *The Star Sea*.

troublesome. On those grounds, it is suggested that the adoption of the other branch of remedies would be better.

- The common law rule of forfeiture, which has been tested by the courts several times, is a feasible remedy against fraudulent claims, and alongside with the contractual remedies, is also capable of serving the purpose of preventing and deterring the fraud. Therefore, when the question "does the punishment fit the crime" is asked, that may be answered in positive and with confidence too.

CHAPTER FIVE

ECONOMIC ANALYSIS ON FRAUDULENT CLAIMS IN COMMERCIAL INSURANCE-WITH PARTICULAR EMPHASIS ON THE REMEDIES

"For the rational study of the law the black-letter man may be the man of the present, but the man of the future is the man of statistics and the master of economics...We learn that for everything we have to give up something else, and we are taught to set the advantage we gain against the other advantage we lose, and to know what we are doing when we elect."

Oliver Wendell Holmes, *The Path of the Law*, 10 Harv.L.Rev.457, 469,474

I. Methodology:

The New Trend of Legal Research and the Possibility of Economic Evaluations on the Fraudulent Claims in Commercial Insurance Law

[5.1] Six years ago in 2006, Professor Roger Brownsword has raised in his paper "An Introduction to Legal Research"[306] an interesting question: "what on earth occupies legal researchers? What precisely do academic lawyers do? "

He has observed that if the question had been asked thirty or forty years ago, the answer would be relatively easy: most of the research and writing at that time were focusing on so called black-letter legal scholarship, that is to say, the attention was drawn to the exposition and analysis of legislation and case-law, the integration of statutory provisions and judicial pronouncements into a coherent and workable body of doctrine.

[306] http://www.wellcome.ac.uk/stellent/groups/corporatesite/@msh_grants/documents/web_document/wtx030897.pdf, accessed on 4th April 2012

[5.2] This kind of legal analysis has been conducted in the first four chapters of this thesis: the meaning of fraud, the categories of fraudulent claims in commercial insurance law and particularly types of various remedies adopted by courts against fraudulent claims have been explored and analyzed. With particular regard to the last point, which is the central part of the whole thesis, the tentative conclusions are as follows:

- The remedy provided by Section 17 of the Marine Insurance Act 1906, namely avoidance *ab initio*, is probably not an appropriate remedy.
- The contractual approach should be preferred:
    - First of all, it is desirable that the insurance contract contains an express fraudulent claim clause and the consequence of breach will then depend on the interpretation of the particular clause in question.
    - Secondly, if there is no express term, a term should be implied in any event by law and the insurer should be entitled to reject the fraudulent claim and/or terminate the contract accordingly.

[5.3] However, Professor Roger Brownsword holds the view that the situation may have changed in the recent years. While academic lawyers continue to provide work for the reference of practitioners, legal research has gained a much boarder compass. It seems to be a trend that the academic lawyers are more integrated into the university community, developing an interdisciplinary- philosophical, sociological, economic, historical- research that is focusing on the practicing and evaluation of law in a broad sense.

[5.4] With regard to the research target of this thesis, from the point of view of law, the majority of the approaches to reducing insurance fraudulent claims have focused upon on identifying the categorization and perpetrators of such behavior and remedies available to punish such behavior, rather than understanding why insured commits insurance fraud and thus, providing knowledge that allows fraud to be approached

from the behavioral-change perspective.[307] A research gap seems to exist here. Accordingly, it is the intention of this chapter of the thesis to fill the gap by jumping out of the parochial dimension of the tradition black-letter research and catching up with this new trend, namely, a broad line research, in particular economic research of law.

[5.5] Before starting to explore the details, the first question (perhaps the ultimate one) that needs to be answered is this: why choose economics as auxiliary methodology and will an economic approach work in analyzing insurance law particularly the problem of fraudulent claims?

[5.6] It may be held that economic analysis has no contribution to make when the legal issues are non-economic ones. However, the basic criticism to this argument is that law and economics are actually closely inter-connected. Generalizing, economics is the science of rational choice. It is the study of rational behaviour in the face of scarcity.[308] If there were an abundance of every good thing, there would be no need for law. Choice is central to most legal disputes. The contractor chooses to deal. The criminal chooses to commit the crime. Whenever there is a question of choice, economics could provide a behavioral theory to predict how people respond to laws and it has something to say that will be relevant to the understanding of existing laws and possibly to the shaping of new ones. [309] In addition, economics could also provide

---

[307] This theory suggests that a reasoned individual will consider the consequences of his behaviour before deciding whether or not to perform this particular behaviour. That is to say, a reasoned individual will response to incentives in the sense that "if a person's surroundings change in such a way that he could increase his satisfactions by altering his behavior, he will do so." Posner, *Economic Analysis of Law*, 7th edn, Wolters Kluwer (2007), 4

[308] See Robbins, *An Essay on the Nature and Significance of Economic Science*, Macmillan (1907), where the author defined the economics as "the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses".

[309] Cooter, R & Ulen, T, *Law & Economics*, 5th edn, Pearson (2008), 4. This approach is also called positive economic perspective, which intends to ask "if the legal policy is adopted, what predictions can we make as to the probable economic impacts of the policy, given the ways in

a useful normative standard for evaluating the law and policy.[310] As the laws are instruments for achieving important social goals, the judges and legislators must have a method of evaluating laws' effects on important social values such as justice in the pure law context and efficiency in the context of economics. [311] A classical illustration could be found in a milestone book of law and economics written by Judge Posner: [312]

> "Although economist cannot tell society whether it should seek to limit theft, he can show that it would be inefficient to allow unlimited theft and can thus clarify a value conflict by showing how much of one value-efficiency-must be sacrificed to achieve another. Or, taking a goal of limiting theft as given, the economist may be able to show that the means by which society has sought to attain that goal are inefficient-that society could obtain more prevention, at lower cost, by using different methods. "

Therefore, it may be neatly concluded that economics provide a very useful consideration for the judges and law makers to take account of, as it is said that "it is always better to achieve any given policy at lower cost than at higher cost"[313] so "as judges, and inevitably as lawmakers, we must not make laws without regard to their full costs and benefits to the community".[314]

---

which people are likely to respond to the particular incentives or disincentives created by the policy." See Trebilcock, MJ, *The limits of Freedom of Contract*, Harvard University Press (1997), 3

[310] This is the normative economic analysis of law, which tends to ask "is it likely that this particular transaction, or this particular proposed policy or legal change, will make individuals affected by it better off in terms of how they perceive their own welfare". See Trebilcock, MJ, *The limits of Freedom of Contract*, Harvard University Press (1997), 4

[311] Cooter, R & Ulen, T, *Law & Economics*, 5th edn, Pearson (2008), 4. "Efficiency" means the allocation of resources in which value (which is measured by the willingness of a reasoned person to pay) is maximized. There are two concepts of efficiency: Pareto Efficiency and Kaldor-Hicks efficiency. As will be introduced below, for the purpose of analysis in this thesis, the concept of Pareto Efficiency will be adopted expect the situations where bankruptcy is considered. See [5.27] below

[312] Posner, *Economic Analysis of Law*, 7th edn, Wolters Kluwer (2007), 24-25

[313] Cooter, R & Ulen, T, *Law & Economics*, 5th edn, Pearson (2008), 4

[314] Duggan, *Commercial Law and the Limits of the Black Letter Approach*, in Worthington, S, (ed.), *Commercial Law and Commercial Practice*, Hart Publishing (2003), 596

[5.7] Furthermore, in the insurance context with regard to the function of economic analysis, the eminent economist David Friedman once said in his book *Law's Order: what economics has to do with law and why it matters*:[315]

> "The economic analysis of insurance activities was worked out well before the economic analysis of law. The economics of insurance-why people buy it, what costs are associated with it, and how they can best be minimized-provides a useful shortcut to understanding a wide variety of legal issues."

As a matter of fact, it seems that some economic theories have already worked well in one of the most important part of insurance law, namely the law of disclosure. In another important book of law and economics: *Game Theory and Law*, the author stipulates:[316]

> "Situations in which one player possesses knowledge that the other does not, this informational asymmetry itself can affect the way each player behaves; and the legal rules can play a large role in determining how parties share information with each other. Indeed, many important legal reforms have focused on information and whether and how it is conveyed. Laws, for example, may mandate disclosure of information."

Basically speaking, fraudulent claim can be regarded as a situation of informational asymmetry: the insured possesses more information about the loss than insurer. Accordingly, whether or not the same analysis could work properly in post-contractual stage requires further discussion.

[5.8] In conclusion, the essential theme of economic approach uses "the principle of economic efficiency as an explanatory tool by which existing legal rules and decisions may be rationalized or comprehended.",[317] and clearly the economic approach could be used to analyze insurance problem. As Judge Posner suggested that "the theory has

---

[315] Friedman,D, *Law's Order: What Economics Has to Do With Law and Why It Matters*, Princeton University Press (2000), 121

[316] Baird &Gertner &Picker, *Game Theory and Law*, Harvard University Press(1994), 77

[317] Coleman, *Efficiency, Exchange and Auction: Philosophical Aspects of the Economic Approach to Law*, 68 California Law Review, 221-249, 221

normative as well as positive aspects",[318] this chapter will develop the discussions in those two aspects respectively:

(1) First of all, an economic approach will be adopted to evaluate the conclusions reached with regard to the remedies available for presentation of fraudulent claims. In this sense, the research is normative as it is focusing on the evaluation of current legal status with the intention of improving it.

(2) Secondly, the perspective of economics will be introduced to the discussion on the possibility of prevention and minimize the fraudulent claims in commercial insurance law. In this respect, the research is positive as it is an attempt to explain legal rules and outcomes in the stamp of economic reasoning.

II. The Economic Evaluation of Section 17 in the Post-contractual Context

A. The informational asymmetry in insurance contract and the comparison of economic function of Section 17 in the pre-contractual and the post-contractual stage

(a) An introduction to informational asymmetry

[5.9] The most basic question which economic analysis attempts to emphasize is how to organize the system of production and transaction of goods, to best satisfy people's wants and needs, from scarce recourses? The meaning of "best" should be defined in the first place. For the purpose of the thesis, two criteria for judging social welfare outcomes are used. The first is "Pareto-efficiency". It basically means if the welfare of no single person or group can be improved without reducing the welfare of some other person or group, an outcome is Pareto-efficiency.[319] The second is "Kaldor-Hicks efficiency". In essence, the economic analysis on the basis of Kaldor-Hicks criterion is a cost-benefit analysis. A project is workable if its benefits exceed

---

[318] Posner, *Economic Analysis of Law*, 7th edn, Wolters Kluwer (2007), 24

[319] Pareto efficiency means a particular situation in which it is impossible to change it so as to make at least one person better off without making another worse off. Cooter, R & Ulen, T, *Law & Economics*, 5th edn, Pearson (2008), 17. See below, at [5.40] for the application of this criterion.

its costs (benefit/cost includes both private and social benefit/cost). When discussing social welfare, Kaldor-Hicks criterion is a better one than Pareto criterion.[320]

[5.10] One of the symbols of human civilization is the social division of labors, the advantage of which is that in most economic activities there are usually some production gains to be made by specialization. In order to take this advantage, people must interact via transactions, which are completed through "contracts". Insurance transactions make no difference on this part. Insured, choosing to give up a certain amount of income (usually called premium) to avoid having to face uncertain outcomes, transfers the risk of the uncertain event to the professional risk bearer namely the insurer. The risk-averse insured consider himself better off with the lower certain income than facing the uncertain higher income and the insurer, relying on the law of large numbers, may consider himself better off with the income of premium.[321] Ideally, if the insurance contract being complete in the sense that parties to the insurance contract could specify their respective rights and duties for every possible future state of the world, insured and insurers are both better off from trading insurance and no one is worse off. A Pareto efficient outcome is produced. However, the reality is always harsh and problems arise in insurance transactions due to the fact that parties in transactions do not face the true cost of their actions. The conflict between the insured's utility and that of insurer's may be created and mutually

---

[320] Cooter, R & Ulen, T, *Law & Economics*, 5th edn, Pearson (2008), 47. See below, at [5.27] for the application of this criterion.

[321] The fact that the insurer, as professional risk bearer, is willing to bear to risk is not because they prefer uncertainties or they are risk-seeking or risk-preferring people but due to the fact that being subject to a very large number of similar risks they may be able to apply the law of large numbers to reduce or even eliminate risk. The law of large numbers holds that if enough cases could be observed, the uncertainty or risk present in the individual instance would disappear in the mass. In other words, as the number of trials increases, unpredictable events for individuals become predictable among large groups of individuals. For example, it would be impossible to predict whether a man's house would be burned down in the next year but the occurrence of fire in a city is regular enough so that insurers can approach without difficulty the objective probabilities. By insuring a large number of people with similar risks, insurers could predict the total amount of claims, determine the appropriate premium and eventually fulfill the goal of profit-maximizing.

beneficial exchanges may be precluded. This conflict is usually referred to as incompleteness of the insurance contract, and one of the main reasons causing incompleteness is the informational asymmetry between insured and insurer.

[5.11] Sometimes one or more of the parties to a contract may possess exclusive information. Such information is said to be "privately observed" by those who have access to it and "unobservable" to those who do not. One of the most prominent economic theorists of the twentieth century Kenneth J. Arrow classifies such informational advantages as "hidden actions" and "hidden information".[322] Hidden actions involves actions which cannot be accurately observed by others e.g. criminal activities, and hidden information involves those which determines the appropriateness of one party's actions but which cannot be observed costlessly by the other party to the contract. In short, asymmetrical information includes information that cannot be observed or those can be observed but too costly which will result in the ignorance of the information.

[5.12] Although morally reprehensible, one of basic assumption of economic theory is that human beings are greedy; they may do anything to produce profit or utility, even if in certain circumstances lying and cheating. This weakness of human beings has been perceived long time ago as Machiavelli advised in his significant book *The Prince* that:[323]

> "A wise ruler, therefore, cannot and should not keep his word when such an observance of faith would be to his disadvantage and when the reasons which made him promise are removed. And if men were all good, this rule would not be good; but since men are a contemptible lot and will not keep their promises to you, you likewise need not keep yours to them."

People do not always lie when they have informational advantages. Exchange of information may be beneficial to create the perfect contract but it inevitably involves

[322] See Arrow, *The economics of agency*, in *Principals and Agents: the structure of business*, Pratt & Zeckhauser (Ed), Harvard Business School Press (1991), 37-51

[323] Machiavelli, *The Prince*, Chapter XVIII

transaction costs such as time and out-of-pocket expenses. Transaction costs do not increase utility of parties, and if the transaction costs are too large, it may jeopardize the cooperation within contractual relations and obstruct bargaining. To avoid transaction costs, people may choose not to transmit information or even lie or withhold information in order to gain an advantage in bargaining. Furthermore, people will be inclined to use informational advantage when they perceive that they can gain something by such behaviour.

(b) Informational symmetry in the pre-contractual stage of insurance contract

[5.13] The insurance contract is a typical asymmetry information contract. In 1759, the governor of Fort Marlborough, being afraid that the fort would be attacked by the French, involved himself in an insurance transaction against the fort being taken by foreign forces, but the governor had not disclose to the insurer his concerns about the probability of attack and vulnerability of the fort. Lord Mansfield commented that: [324]

> "The special facts, upon which the contingent chance is to be computed, lie most commonly in the knowledge of the insured only; the underwriter trusts to his representation, and proceeds upon confidence, that he does not keep back any circumstance in his knowledge, to mislead the underwriter into a belief that the circumstance did not exist, and to induce him to estimate the risqué, as if it not exist."

[5.14] The essence and significance of Lord Mansfield's judgment in *Carter v Boehm* has been thereafter codified into the Section 17 of the Marine Insurance Act 1906 with the headline of "Insurance is *uberrimae fidei*" which provides 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 duty established by Section 17 is customarily referred to as the duty of utmost good faith and obviously the most important economic function of it is to correct the informational asymmetry between the insurer and insured. At the pre-

---

[324] *Carter v Boehm* (1766) 3 Burr.1905, 1909. See Chapter Four, at [4.78]

contractual stage, the strict disclosure obligations enshrined in Sections 18 and 19 of the Marine Insurance Act 1906 functions as a mechanism to compulsorily transmit the information that otherwise would not have been forthcoming and ensure that the underwriter is made familiar with all the data which might influence his decision to underwrite the risk. In the context, one of the basic elements of contractual formation, namely meeting of minds, could not be achieved unless the disclosure requirement is fulfilled.

(c) Informational symmetry in the post-contractual stage of insurance contract: the important role of investigation

[5.15] The asymmetrical information exists not only before the conclusion of insurance contract but also exists during the performance of the contract particularly at the claim stage. The subject-matter of insurance has always been under the observation or knowledge of the insured and it may economically be impossible for the insurer to monitor the subject-matter of insurance. As long as the risk increases, the insured is usually able to get the information faster than insurer. The insured knows the accident in the first place and the insurer finds out about the situation at a later stage, there is a time gap between the acquisitions of information. Secondly, the insured knows better regarding the level of the accidents. The insurer might only acquire information reaching the level of the insured only after conducting investigation with the help of the insured. When a claim is submitted, the insurer may choose to rely entirely on the insured's presentation, directly accepts the claim and quickly makes the payment, but this is not the common way for the insurer to proceed, especially if there are the traces of fraud indicators. The insurers will usually have their own systems of claims investigation so they can attempt to only pay the legitimate claims. As it will be demonstrated below, the system of claims investigation plays a significant role to correct the post-contractual informational asymmetry in insurance contract.

[5.16] Investigation would always be a better choice for the insurer to control claims that carry apparent characteristics which are associated with a potential for fraud and

then to deny those claims which are found to be fraudulent. The interaction between insured and insurer could be analyzed from the point of view of game theory.[325]

[5.17] Take a fire insurance case as an illustration: when the subject-matter of insurance is damaged in the accident, the insurer and the insured have the common knowledge regarding the happening of the accident but the extent of the loss is the personal information of the insured. There could be two levels of loss with regard to subject-matter of insurance: high and low. Under those circumstances, insured could honestly report the extent of the loss but they also report the high level of the loss when the extent of the loss actually being low in order to claim more indemnities which could be regarded as a kind of fraudulent claims. When receiving the claim for indemnity, insurer will start the procedure to investigation the claim. As cost will be involved in the investigation, insurer will design the pointed investigation strategy e.g. routinely or carefully, according to the chosen action of insured and the information they have gathered. If the fraudulent claim is discovered in the investigation process, insured will be punished in the sense that they may commit financial crime or may suffer a reputation loss or they may receive the negative utility due to rejection of the claim or possible termination of the contract.

[5.18] A game theory model will be established as follows for the purpose of analysis, but a few explanations should be made in the first place. To begin with, it shall be kept in mind that "the ultimate test of game theory as applied to the analysis of legal rules or anything else is whether it sheds light on how individuals are likely to behave",[326] and accordingly the purpose of current analysis is to find out how the insurer shall conduct the investigation in response of insured's indemnity request; Secondly, this model is a game of incomplete information, that is to say, the analysis

[325] In essence, investigation and its subsequent impact on insured could be regarded as a strategic behavior, in the sense that this is a situation where insured and insurer interact with each other and each one's decision turns on what that individual expects the others to do. It is suggested that game theory could be a very powerful tool to offer the insights into this strategic behavior. See Baird &Gertner &Picker, *Game Theory and Law*, Harvard University Press(1994), 1

[326] Baird& Gertner& Picker, *Game Theory and Law*, Harvard University Press(1994), 125

will be premised on the situations in which insured possesses knowledge that insurer does not; Thirdly, the model is further established on the basis that the individual who does not possess the information could only draw the inference from the actions that the informed party takes.[327] Fourthly, it is submitted that the legal rules could have the impact on the actions that individuals take and then affect the way information is transferred between parties.[328] Therefore, the purpose of this model is to evaluate the relevant legal rules influencing "the ability of parties to signal information or to screen it".[329] In the present context, the insured is the informed party, the insurer is the uninformed party, thus the purpose of analysis is also to merit the impact of investigation conducted by insurer on the inclination of the insured to reveal the information (this is called the process of information screening in game theory).

[5.19] It is submitted that "the way to model non-verifiable information is to posit that the information has a binary character".[330] In the present case, the insured knows there are two levels of loss: low and high. In this game, a hypothetical player, who can be called as Nature, has the first move. Nature decides whether the subsequent course of play will involve the high level of the loss or the low level of the loss, and then insured and insurer (two players) will join the game. Each of them has one move and must choose between two actions, namely the insured decides the extent of the claim and after the action of the insured, insurer decides the investigation strategy: routinely or carefully. Assuming that: (1) Insurance contract stipulates that: upon the happening of the low level loss, the indemnity is 100; upon the happening the high level loss, the indemnity is 200; (2) Premium is 10; (3) The cost of routine audit (R) is 20 and the cost of careful audit (C) is 40; (4) The punishment when the fraud being

---

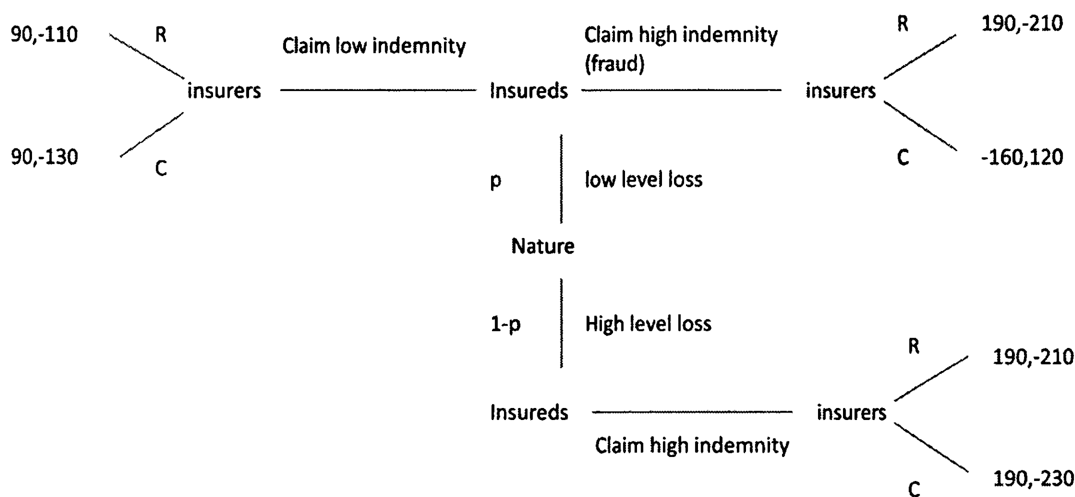
[327] The information in this instance is defined as non-verifiable information in the sense that one party will possess private information that neither the other party nor any third party can acquire directly. Baird& Gertner& Picker, *Game Theory and Law*, Harvard University Press(1994), 122

[328] *Ibid.*,123

[329] *Ibid.*, 123, 125. Information signaling and information screen are two unique concepts in game theory: signaling takes place when those who possess non-verifiable information can convey that information in the way they choose their actions. Screening takes place when the uninformed players can choose actions that lead informed players to act in a way that reveals information.

[330] *Ibid.*,126

discovered is F, and for the present purpose F=50; the game strategy could be displayed in the following extensive chart form. At every move, the uninformed player, namely insurer, has an information set that contains two nodes.[331] Each node stands for the decision that emerges after Nature has chosen an informed player of one type or the other (low-level loss of insured or high-level loss). The first number stands for the utility of the insured and the second one means the utility of the insurer. What need to be found is the combination of strategies the players are likely to choose in which no player could do better by choosing a different strategy given the ones the other choose, and it can be done by calculating and observing the payoffs[332] to each player that result from each possible combinations of actions.



[5.20] By observing the payoffs that derive from the strategies, it could be concluded that

- If the insured honestly report the level of loss and claim the corresponding indemnity, the best strategy for the insurers is to conduct routine investigation;
- If the insurers conduct the routine audit, no matter what level the loss is on,

[331] In the context of game theory, "node" means "the fundamental building block of the extensive form game. It is a point at which a player takes an action or the game ends. Each node is therefore either a decision node, a point at which a player must choose between different courses of action, or a terminal note, which sets out the payoffs that each player receives." *Ibid.*, 311

[332] In the context of game theory, "payoff" means the utility a player derives under a particular combination of strategies. *Ibid.*, 311

the best strategy for the insured is to claim high indemnity;

- If the insurers conduct the careful investigation, the best strategy for the insured is to honestly report the situation of the loss.

[5.21] However, the above model implies that the strategy of the insurer is deterministic, which means that insurer will always investigate for some losses. The cost for this deterministic investigation strategy could be excessively high. Therefore, a more cost-efficient strategy for the insurer could be random investigation strategy in the sense that the insurer may reduce the probability of investigation, because the purpose of investigation is to induce the insured to tell the truth and the insured may tell the truth as long as investigation is frequent enough. In this situation, the punishment imposed when the fraud is discovered becomes more important: for example, if the punishment factor F is extremely high, then even if the insurer investigation seldom investigated the insured will choose to tell the truth. Therefore, the above conclusion might be amended as that: Under the certain probabilities, as long as the punishment factor F is strong enough, even if the insurers decide to conduct routine audit, it is less likely that the insured would submit an exaggerated claim in the low level loss situations.

(d) Conclusions

[5.22] After reviewing the nature of informational asymmetry and comparing the way to correct information asymmetry at pre- and post- contractual stage, two tentative conclusions could be drawn:

(i) The way to correct information asymmetry at post-contractual stage (claim stage in particular) is dramatically different from that at the pre-contractual stage. At pre-contractual stage, the approach is negative in the sense that the insurer must put much weight on the voluntary disclosure of the insured; However at post-contractual stage, the approach is positive in the sense that the insurer relies very much on his own initiative investigation to gather the information with the co-operation of the insured. As the investigation progresses the imbalance between the insured's and the insurer's knowledge declines and equilibrium is closely approached. Accordingly, it may be

concluded that the informational symmetry is achieved by the efforts of insured required by law in the pre-contractual stage but to a large extent by the endeavors of insurer himself in the post-contractual stage. Therefore, emphasis could not be placed too much on Section 17 in the post-contractual stage, for instance, if the investigation being hindered by insured, insured is not in breach of Section 17 but in breach of duty to co-operate which could well be a contractual duty.

(ii) Investigation is significant and is a better choice for the insurer to detect fraudulent claims but may not be the best as the investigation costs time and money. Given the cost of investigation, random investigation strategy could be better than deterministic investigation strategy. Accordingly, insurer may not choose to investigate a claim when it lacks of observable indicators from which fraudulent behavior may be definitively inferred. However, the fact that fraud indication could not be sensed does not mean that there is no fraud. If this is the situation, the function of remedy becomes more significant in the sense that if the fraud could not be detected ex-ante it should be punished ex-post. The discussion above shows that punishment factor is important in the post-contractual stage but it does not necessarily mean that the remedy with high punishment element is an appropriate remedy. Therefore, the next section will be devoted to the discussion on the economic effect of remedy provided by Section 17.

B. The economic insight of the remedy provided by Section 17 in the post-contractual stage

[5.23] It has been concluded in the last chapter that at the current stage, the only remedy available for breach of Section 17 is avoidance *ab initio*, and the starting point to discuss the economic impact of this remedy is the judgment delivered by Lord Hobhouse in the momentous case *The Star Sea*,[333] in which his Lordship concisely pointed out that:[334]

> "The result is effectively penal."

[333] [2001] 1 Lloyd's Rep.389

[334] *Ibid.*, 400

He went on to provide the following illustration:[335]

> "Where a fully enforceable contract has been entered into insuring the assured, say, for a period of a year, the premium has been paid, a claim for a loss covered by the insurance has arisen and been paid, but later, towards the end of the period, the assured fails in some respectfully to discharge his duty of complete good faith, the insurer is able not only to treat himself as discharged from further liability but can also undo all that has perfectly properly gone before."

[5.24] Admittedly, avoidance *ab initio* of penal nature could indeed provide incentives to the insured not to submit fraudulent claims since the consequence is essentially serious and it seems paradoxical that the heavier the sanction for the submission of fraudulent claims the less likely a breach will be committed. The punishment factor is indeed strong enough in the context provided by the last section's analysis. However, it shall be stressed again that punishment is not the only consideration of deciding whether the remedy is appropriate or not. Four economic criticisms could be provided to lend support to the argument that avoidance *ab initio* in this context could be the inappropriate remedy.

[5.25] First of all, the powerful, penal and wholly one-sided remedy may trigger the moral hazard[336] problem on the part of the prospective victim of fraudulent claims and induce him to over-invoke this remedy in the sense that insurer has more to gain from the breach and the insured's duty of good faith may be used by the insurer as an "indispensable shield for the underwriter into an engine of oppression against the assured"[337] and an instrument for enabling the insurer himself to act in bad faith e.g.

[335] *Ibid.*

[336] As it will be submitted later, the concept of moral hazard in insurance context usually refers to the ex-post opportunistic behaviour on the part of the insured. However, nothing in principle could prevent the insurer to commit the moral hazard act. In essence, moral hazard is not a problem with regard to morality but from the perspective of economics, it is a problem in respect of motivations or incentives. See below, at [5.32]-[5.33]

[337] *Commercial Union Assurance Company Limited v The Niger Company Limited* (1922) 13 Ll.L Rep.75,82 (Lord Sumner)

unreasonably rejecting a claim and avoiding the contract,[338] with the result that the number of litigation may be increased. Although this is relatively speculative, it is not unlikely that the increased number of deterrence of breach may be offset by an increased degree of litigation on the subject. In addition, litigation may be very costly to the parties and the court system. Since one of the objective of a procedural system, viewed economically, is to minimize the cost of operating the procedural system,[339] and courts are "in their function of declaring, clarifying and extending legal principle must take seriously the economic consequences of what they are doing",[340] so they may consider the possibility not to enforce a remedy that makes litigation more likely.

[5.26] Secondly, the remedy of avoidance *ab initio* may lead the insurer to think that he is well-protected in the case of fraudulent claims not only because he can reject the current claim in question but also because he can escape retrospectively the liability to indemnify which he has previously and validly undertaken.[341] Thus, the fearless insurer, when choosing the appropriate contracting party, may less consider the credibility of insured. The fact that a less creditworthy insured has more motives and opportunities to submit fraudulent claims may possibly result again in the appearance of more costly litigations. A similar situation could be encountered in bankruptcy law in the sense that giving the creditor better remedies in bankruptcy may embolden or encourage creditors to lend money to less creditworthy borrowers, as Judge Posner described that: [342]

---

[338] In *Carter v Boehm* (1766) 3 Burr 1905,1910,1919, Lord Mansfield has warned that the rule against wilful concealment must be "restrained to the efficient motives and precise subject of any contract" and the natural law, namely fairness, has required this part of law should not be used as a means of perpetrating a fraud. In *The Star Sea* [2001] 1 Lloyd's Rep.389, [55], Lord Hobhouse clearly declared that: "The duty of good faith is even-handed and is not to be used by the opposite party as an opportunity for himself acting in bad faith."

[339] Posner, *Economic Analysis of Law*, 7th edn, Wolters Kluwer (2007), 593

[340] Kirby, *Comparativism Realism and the Economic Factor-Fleming's Legacies*, in Mullany, NJ & Linden, AM (Ed), *Torts Tomorrow: A Tribute to John Fleming*, North Ryde (1998)

[341] [2001] 1 Lloyd's Rep.389, 401

[342] Posner, *Economic Analysis of Law*, 7th edn, Wolters Kluwer (2007), 431. This paragraph also partly explained the reasons of sub-prime lending crisis in USA.

> "Some states have generous household exemptions for insolvent debtors, others chintzy ones. In the former states, the risk of entrepreneurship is reduced because the cost of failure is less, but interest rates are higher because default is more likely and the creditor's position in the event of default if weaker. Higher interest rates in turn make default all the more likely. Cutting the other way, however, is the fact that is low-exemption states lenders' risk is less, which induces lenders to make more risky loans-loans likelier to end in bankruptcy."

[5.27] Thirdly, avoidance *ab initio* is particularly inappropriate in situations in which a single false claim is submitted very late in the currency of a long-running policy, where insurers are allowed to retrieve all the money they paid in the previous innocent claims. The insurers are not only potentially overcompensated.[343] But more importantly, assuming[344] that (i) insured have to pay back what he have received for those innocent claims; (ii) the amount of those indemnities is huge (e.g. usually in marine insurance the indemnities for a total loss ship or a shipment of cargo will be a large sum of money); (iii) the insured very much relied on those indemnity to continue the operation of his business, his cash-flow may therefore be seriously and detrimentally affected, ultimately resulting in the risk of bankruptcy on the part of insured. Bankruptcy is not a positive thing from the point of view of social cost control.[345] Situations may be more serious in the period of economic depressions and

---

[343] Considering the potential gain from overcompensation, insurer may even induce the insured to commit the breach. Mahoney, *Contract remedies: general*, Chapter 9 of *Contract Law and Economics*, Geest (Ed), Edward Elgar (2011), 168.

[344] The following analysis may be a bit speculative because it is established on too many assumptions, but this is the way of economic analysis at this stage. In recent decade, economics has been criticized because it relies on unrealistic, unverifiable, or highly simplified assumptions, in some cases because these assumptions simplify the proofs of desired conclusions. See Rappaport , *Abstraction and Unrealistic Assumptions in Economics*, Journal of Economic Methodology, 1996, 3(2), 215–236. More and more technical and mathematical tools have been introduced into the economic analysis, in order to change the stream of methodology. Nevertheless, those changes are all beyond the scope of this dissertation and accordingly, the traditional approach is still adopted for the current purpose.

[345] Judge Posner said that: "Bankruptcy imposes deadweight social losses-that is, it causes not just a transfer of wealth from shareholders, managers, and some creditors to other creditors but also

recessions when cash-flow basically means everything to the business men. Therefore, a macroeconomic argument against this penal remedy with retrospective effect is that if it was adopted, this would increase the instability of the business cycle by making the number of bankruptcies greater than it is particularly in the period of economic depressions and recessions. This position may be regarded as inefficiency from the perspective of Kaldor-Hicks criterion as the remedy seems to generate too much social cost and thus unlikely to be able to maximize social welfare for contracting parties generally in the long-run.[346]

[5.28] Finally, It has been concluded in Chapter Four[347] that if the remedy of avoidance is going to be adopted, a complicated legislative reform will become necessary, but from the perspective of economics, the cost of legislative reform is high because it requires the consent of a majority of the legislators. The more parties involved, the higher the transaction costs will be.[348] However, if the law is improving within the ambit of precedent, the cost will not be as high as the process of legislation because the parties and the courts are enabled to use the "information that has already been generated (often at considerable) expense".[349] Despite that the change of social and economic situations may make the precedent less valuable, it is still suggested that individual's legal rights and obligations should be decided in accordance with precedent as possible as it could be, not only because it creates certainty that could

---

the consumption of valuable resources (lawyers' and bankers' and judges' time beyond what would be consumed in ordinary collection litigation) as well as the reductions in the efficiency of asset use discussed above-anything that increases the risk of bankruptcy imposes a social cost." Posner, *Economic Analysis of Law*, 7th edn, Wolters Kluwer (2007), 431

[346] This argument is very similar to the argument advanced by Judge Posner when he criticized the existence of penalty clause in contract law by saying that: "penalties increase the risk of bankruptcy consequent on contractual default, and by doing so increase the number and hence total cost of bankruptcies." Posner, *Economic Analysis of Law*, 7th edn, Wolters Kluwer (2007), 129. See also, Farber, *Contract law and Modern Economic Theory*, 78 Northwest University Law Review (1983).303,335

[347] Chapter Four, at [4.154]

[348] Posner, *Economic Analysis of Law*, 7th edn, Wolters Kluwer (2007), 586

[349] *Ibid.*, 591

reduce costs (the benefit of certainty may exceed the benefit of overruling the precedent without caution) but also because the path dependence phenomenon[350] will make the business and individual bear more cost of adapting to a legislative big change in law by changing the practices that they had already adopted in reliance on the law before it changed.[351] In this context, precedent indicates the common law rule of forfeiture and the contractual approach, and the conclusion of the above analysis is that: if it is unnecessary, deviation is not demanded and resolving the issues within the area of precedent and sticking closely to it would be more efficient.

C. Conclusions

[5.29] To sum up, the duty of utmost good faith enshrined in Section 17 of the Marine Insurance Act 1906 does not perform the same economic function at the post-contractual stage, particularly claim stage, as it does at the pre-contractual stage because the most important method available for the insurer to approach the informational symmetry namely investigation has little to do with Section 17. In addition, while it may deter fraud to a certain extent, the remedy available for the breach namely avoidance *ab initio*, analyzed economically, may also bring more costly litigations and may yield more social cost. In the view of the author, this remedy remains an inappropriate one from the perspective of economics.

[350] Basically, path dependence phenomenon means where we go next depends not only on where we are now, but also upon where we have been. Path dependence phenomenon is a particularly important consideration when analyzing the problem of common law system because this legal system is primarily made by judges rather than legislators. The judge-made law stands for the history of the legal system and must be taken into account when considering any legal reform problem. See generally Posner, *Economic Analysis of Law*, 7th edn, Wolters Kluwer (2007), Chapter 8 and particularly at 591

[351] Posner, *Economic Analysis of Law*, 7th edn, Wolters Kluwer (2007), 592

III. The Economic Evaluation of The Contractual Approach

A. Introduction: the function of contract law in deterring the opportunistic behaviours

[5.30] Under the assumption that Section 17 and the remedy encapsulated in that section could not yield efficient economic results, it is essential to move the debate forward and evaluate whether contractual remedies could provide efficient outcomes when it comes to deterring fraud.

[5.31] The discussion still needs to start with the analysis of informational asymmetry. The existence of asymmetric information could hamper the relationship within insurance contract, because it raises the possibility of opportunistic behaviour. From the perspective of information economics, one of the obvious opportunistic behaviours is referred to as "moral hazard".[352] Moral hazard usually relates in the insurance transactions to the phenomenon that once people take out an insurance policy, they deliberately or recklessly take more risks as a result.[353] Take one simple

---

[352] More than 200 years ago, Adam Smith has observed this pervasive phenomenon in economic activities. He wrote, using the company activities as an example, that: "The directors of such companies, however, being the managers rather of other peoples' money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own...Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company." See Adam Smith, *Wealth of Nations*, Book IV, Chapter 1. This pheromone does not attract too much attention until one of the most prominent economic theorists of the twentieth century Kenneth J. Arrow produced his famous paper *Uncertainty and the Welfare Economics of Medical Care* (American Economic Review (American Economic Association) Vol.53, No.5 (Dec 1963)) He suggested that moral hazard is present if "The insurance policy might itself change incentives and therefore the probabilities upon which the insurance company has relied. Thus, a fire insurance policy for more than the value of the premises might be an inducement to arson or at least to carelessness."

[353] A good definition regarding moral hazard could be found in Borch, *Economics of Insurance*, North-Holland (1990), 326: "Moral hazard mainly concerns the bona fides of the proposer and is therefore concerns the bona fides of the proposer and is therefore dependent upon his character

business fire insurance as an example: without the insurance, a business man may take several steps to reduce the possibilities of a fire in his premises. It is not costless for him to engage in care. However, with a complete insurance in the sense that full amount of loss is covered, the business man may not choose to engage in the same care level with the insurance as before because fire imposes no cost on him. The cost of a fire to business man appears to be zero, why should he incur the cost of prevention when he does not receive any benefit? Therefore, he may spend less on fire extinguishers and electrician services, smoke indoors, and so on, thereby increasing the likelihood of losses. In some extreme cases, he may even deliberate set his premises on fire to claim on insurance. All in all, the insurers may face hazards when the insured behaves immorally.

[5.32] The moral hazard problem is the result of the rational choice of "economic" human beings, which is one of the externalities that exist objectively in the market. The problem may not be eliminated completely but proper methods could be indentified in order to reduce and control the possibility of its happening and its impact. With no doubt that the presentation of fraudulent claims is a typical type of moral hazard, then the question in general that should be asked is: can the principles of contract law function to control or minimize the moral hazard problem in relation to fraudulent claims?

[5.33] In the free market economy, contract stands for the voluntary exchange, which ideally not only could produce the efficient use of the recourses but also could guarantee the profit that the parties to the contract should earn. However, only when both parties perform their obligations under the contract simultaneously, which is rare, the ideal outcome could be fulfilled. The reality is that most contractual dealings including the insurance contract possess the sequential character of economic activity, which means there will be a time gap between the conclusion of contract and performance of the contract. Cooter and Ulen described that: "The passage of time between the exchange of promises and their performance creates uncertainties and

---

and business integrity. It is essential that the insured be scrupulously honest in all his dealing with his insurers so that he will act with the same prudence as he would do if uninsured".

risks. Uncertainties and risks present obstacles to exchange and cooperation", [354] and opportunistic behaviours including moral hazard is a kind of such uncertainties and risks that would endanger the process of exchange. Assuming there was no contract law then the flood-gates opportunism would have been opened and the ultimate result would be that no one would be willing to perform any non-simultaneity transactions, no one could draw up a future plan, and then the resources could not be properly allocated.

[5.34] Therefore, Judge Posner concluded that: "the basic aim of contract law is to deter people from behaving opportunistically toward their contracting parties, in order to encourage the optimal timing of economic activity and obviate costly self-protective measures".[355] This probably means that, for the propose of current discussion, without resorting to the principles of insurance law, the principles of contract law alone are still able to function as a useful mechanism to prevent or minimize the moral hazard problem in insurance contract. By setting up the appropriate remedy e.g. by making insured's opportunistic behavior worthless to him, contract law is able to deter the fraud, and by making the appropriate incentive insurance contractual arrangements, contract law can also achieve the purpose of deterrence. For the former position, it has been concluded in the last chapter that the parties could expressly agree the consequence of making fraudulent claims, or if there being no express clauses, the law shall imply the similar clause into the contract to achieve the same purpose and accordingly, economic evaluation will be triggered as follows to see whether this contractual remedy could be an efficient one. For the latter position, which will be the topic of next section, the focus will be directed to the economic explanation of various clauses in insurance contract and see how they can fulfill the target of deterring the fraudulent claims.

[354] Cooter, R & Ulen, T, *Law & Economics*, 5th edn, Pearson (2008), 203

[355] Posner, *Economic Analysis of Law*, 7th edn, Wolters Kluwer (2007), 94

B. The economic insight of express fraudulent claim clause

[5.35] In essence, express fraudulent claim clause is an important reflection of freedom of contract, which is the cornerstone of a market economy that believes individuals must be given right to decide their own contractual rights and obligations. Economic approach assumes that, generally, the parties are the best judge of their own welfare and this is particular true in the commercial context because commercial men are usually be treated as professionals. Economic theory also admits that resources tend to flow toward their most valuable use if voluntary exchange is done. Accordingly, when encountering the asymmetric information problem which may lead to the potential fraud, the parties can of course explicitly address the possibility of incomplete information through express contractual terms by *inter alia* stipulating the remedies available if one party wrongly takes the advantage of asymmetric position and the courts, if the meaning of the clause is clear enough, shall not upset this express agreement of the parties. If the analysis ends up here, it may say that the express clause may be the best economic solution to fraudulent claims because it is the consequence of voluntary negotiation and cooperation and both parties to an economic transaction could benefit from it.

[5.36] However, it is almost impossible and impractical that express fraudulent claim clause could be negotiated incidentally and individually every time because too much cost will be consumed in the process of negotiation. Thus, express clause dealing with fraudulent claims usually and practically is in the form of standard clauses in the insurance contracts. The principal justification for the standard clauses is its ability to dramatically reducing the transaction costs in many contexts on the assumption that parties will often not read them or, if they do, will not wish to spend significant amounts of time attempting to renegotiate them.[356] However, this position may bring the criticism that the existence of the standard fraudulent clause is a manifestation of insurer's bargaining power over the ignorant and weak insured as the

[356] Trebilock, MJ, *The Doctrine of of Inequality of Bargaining Power: Post-Benthamite Economics in the House of Lords*, 26 University of Toronto Law Journal 359 (1976)

clauses are offered on "take it or leave it basis" and it is an unfair economic practice, as Professor Trebilcock illustrated that: [357]

> "...to hold parties bound to standard terms which they had entered into but which they had not read or understood does not rest comfortably with a theory of contractual obligation premised on individual autonomy and consent, which may result in the unfair consequence."

[5.37] The arguments to this criticism could be developed in two respects. First of all, the problems of unfairness may not be as severe as they might seem at the first sight. The criticism may stand quite well in the consumer context as many consumers may be relatively ignorant and not good at construing the complicated contractual terms with the result that the market power on consumers is weak. However, the position may be different in the commercial context as Lord Wilberforce held that:[358]

> "In commercial matters generally, when the parties are not of unequal bargaining power, and when risks are normally borne by insurance, not only is the case for judicial intervention undemonstrated, but there is everything to be said and this seems to have been Parliament's intention, for leaving the parties free to apportion the risks as they think fit and for respecting their decisions."

Lord Diplock, in agreement with Lord Wilberforce, also commented that:[359]

> "In commercial contracts, negotiated between businessmen capable of looking after their own interest and of deciding how risks inherent in the performance of various kinds of contract can be most economically borne."

Thus, it is hard to decide firmly on the commercial insurance market that who possesses the more powerful power with the result that the insured may not always be the weak party.

[357] Trebilock, MJ, *The Limits of Freedom of Contract*, Harvard University Press (1997), 119

[358] *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827, 843

[359] *Ibid.*, 851

[5.38] Secondly, the market power may not function as simple as the criticism assumes. The insureds in the market may be divided into two groups: one group is well-informed, sophisticated and aggressive who is more sensitive to the price and values they are able to get from the contract terms offered by insurers. They either negotiate over those terms and if they are not satisfied they may switch their business readily to competing insurers offering more favorable terms. Each insurer has to respond to those insureds' demand and reacts to the business practices of his competitors. The existence of this active group brings a beneficial externality to the other inactive group who is not prepared to make the efforts to take care over the terms into which they agree. Contract terms are the outcome of this process, which have already taken into account the demands of insured. In short, it may be concluded the standard terms are not set by individuals directly negotiating over terms but aggregate market forces on a take it or leave it basis.[360] The criticism may not be justified in the context of prevailing economic theories and commercial realities.

[5.39] The meaning of express clause, if there is ambiguity, depends upon the interpretation mechanism adopted by the court. Thus, it is also useful to identify the economic implications that those mechanism is bearing.[361] To start with, two concepts have to be introduced: complete contract and incomplete contract. Complete contract means a contract that provides a complete description of a set of possible contingencies and explicit contract terms dictating a performance response for each of these contingencies [362] and accordingly, it may say that "complete" bears the same meaning with "unambiguous". If a contract is complete, the intervention of court will be unnecessary. However, in real world, most contracts, if not all, will be incomplete because the costs of negotiating a complete contract would be high and in many circumstances would even exceed the benefits that can be received from the

[360] Veljanovski, *Economic Principles of Law*, Cambridge University Press (2007), 132-133

[361] The following arguments could also be used in explaining the justification of implied terms in contract. The standpoint is very similar, as it will be demonstrated below, namely, saving the cost of negotiation. See generally Cohen, *Implied terms and Interpretation in Contract Law*, Virginia Law and Economics Research Paper No. 2009-12

[362] Hart &Moore, *Incomplete Contracts and Renegotiation*, 56 *Econometrica*, 755-785.

performance of the contract. The fact that a contract is incomplete often means that some of the terms of contract may not be clear enough and will be subject to arbitration and litigation, with the result that court must intervene and provide the mechanism to clarify the ambiguities of the terms. Viewed economically, if the *ex-ante* transaction costs is relatively low and acceptable or within the control of the parties,[363] one of the interpretive approaches adopted by the court is to encourage more complete contract by encouraging better contracting, that is to say, encouraging the parties to "facilitate improvements in contractual formulation".[364]

The first rule that makes such economic sense is the *contra proferentum* rule.[365] When facing ambiguities, what the court will do is to make the comparison and identify one party who is in a better position to clarify a term as "cheaper contract drafter" and impose the liability upon this party for the purpose of encouraging him to draft a more complete contract next time. This is the economic implications for the reasons that if the remedy of an express fraudulent claim is not clear (e.g. it does not make it clear whether insurer is allowed to terminate the contract) then the court will be inclined not to enforce this remedy with the view of urging the insurer to make better drafting next time.

The second rule that makes such economic sense is the ordinary meaning rule, as Lord Mustill said that the true interpretation of a contract "will start, and usually

---

[363] For the current purpose, the situation that ex-ante transaction costs is high enough to prevent drafting is not considered because, as it is suggested above, the fraudulent claims clause in most circumstances is a standard clause drafted in advance in the insurance contract; the cost of drafting is within the control of insurers.

[364] Goetz & Scott, *The Limits of Expanded Choice: An Analysis of the Interactions between Express and Implied Contract Terms*, 73 California Law Review, 261-322, 264. However, it is suggested that encouraging better contracting does not necessarily mean encouraging greater contractual completeness. Considering the transaction costs, a more proper way to express this idea may be that it is for the purpose of encouraging contractual incompleteness through reliance on solid interpretive rules and implied terms. Cohen, *Implied terms and Interpretation in Contract Law*, Virginia Law and Economics Research Paper No. 2009-12, at 9

[365] See also Chapter Four, at [4.28]

finish, by asking what is the ordinary meaning of the words used".[366] With regard to the meaning of a particular word, the more common a word is, the more likely the costs of agreeing the meaning of this word are low. Thus, this rule could be viewed as a method of encouraging parties to use and learn the ordinary meaning of the words and therefore reducing the need and the costs of negotiating and providing the definition and explanation of the words in question.[367] This reasoning could justify the proposition that if the parties use "avoidance" as remedy in the express terms dealing fraudulent claims, although the result of breach is draconian, the natural meaning of this word should be adopted and the remedies should be upheld accordingly.[368] The above economic reasoning could also be used in the situations in which the meaning of words shall follow the precedent, usage and custom.

[5.40] In brief, if the express fraudulent claim clause is individually negotiated, it is economically efficient as it is the indication of freedom of contract. In addition, it needs to bear in mind that Coase Theorem[369] proves that in the absence of transaction cost (which will never happen) a contract would be Pareto efficient: the less transaction costs involved in the contract, the more efficient the contract would be. Therefore, if express fraudulent claim clause is the standard term of the insurance contract, it is also economically efficient as it saves the cost of negotiation and therefore reduces the transaction costs, as Judge Posner commented that: "after all, one way to reduce the cost of agreement is to agree on less".[370]

---

[366] *Charter Reinsurance Co Ltd v Fagan* [1997] AC 313, 384. Similarly, in *BCCI v Ali* [2002] 1 AC 251, [39], Lord Hoffmann also said: "the primary source for understanding what the parties meant is their language interpreted in accordance with conventional usage."

[367] Cohen, *Implied terms and Interpretation in Contract Law*, Virginia Law and Economics Research Paper No. 2009-12, at 10

[368] See Chapter Four, at [4.20]-[4.24]

[369] Coase, *The Problem of Social Cost*, 3 Journal of Law&Economics1 (1960). The Coase Theorem may be oversimplified here, but it is unnecessary to elaborate it for the purpose of current discussion. See Posner, *Economic Analysis of Law*, 7th edn, Wolters Kluwer (2007), 50-55

[370] Posner, *Economic Analysis of Law*, 7th edn, Wolters Kluwer (2007), 586

C. The economic insight of implied fraudulent claim clause

[5.41] The conclusion in the legal analysis is that if there being no express terms dealing with the fraudulent claim, a term shall be implied in any event. The economic implications of this conclusion could be identified as follows.

[5.42] Asymmetric information is pervasive in the contracting process. The parties can explicitly allocate the risk of abusing asymmetric information to the insured as he is both the one who can avoid it and who should bear it.[371] On the other hand, the contract may remain silent about this risk. Silence may be left deliberately as the parties are in the opinion that risks do not justify the cost of negotiating and drafting terms to allocate them. In other words, if the parties negotiate express terms to allocate risks, they will definitely bear transaction cost. If they leave it, they will bear the transaction costs with only probability. Briefly, if the cost of allocating a risk exceeds the cost of allocating a loss multiples the probability of a loss, the party will leave the allocation of risk silent.[372] This argument is similar to the use of standard terms to economize on contracting costs.

[5.43] In the event that the loss materializes, it is the job of contract law or the court to supply default terms that fill the gaps in the contract where the parties have not included an express term. When filling the gaps, the court shall act as if the parties had negotiated a term. That is to say, if a court is rightly confident that most parties to such contracts would agree to impose on the insured the obligation not to submit fraudulent claims, then reading such an obligation into every insurance contract that does not mention the obligation avoids costs of negotiation and drafting. The parties can always opt out of such clause, but if they are less likely to opt out than they would be to opt in, the judicial implication of such provision is more efficient. Cooter and Ulen concluded that: [373]

---

[371] Veljanovski, *Economic Principles of Law*, Cambridge University Press (2007), 122

[372] Cooter, R & Ulen, T, *Law & Economics*, 5th edn, Pearson (2008), 218

[373] *Ibid.*, 220

"When law supplies default terms preferred by both parties, they can omit these terms from the contract. By omitting these terms from the contract, the parties can focus their negotiations on other terms. The fewer the terms requiring negotiation, the cheaper the contracting process. Thus, the law can save money for contracting parties by supplying efficient default terms to fill gaps in contracts."

[5.44] It may be concluded so far that implication of a clause dealing with the risk of fraudulent claims is efficient. In addition, it may also need to consider the consequence of breach: efficient contractual remedies shall be able to deter breaches of contracts. In this regard, common law rule of forfeiture can fill the gap and can be used jointly with the implied contractual approach with the effect that the particular claim tainted by the fraud could be wholly rejected and any interim payment made to this claim could be recovered back. Although it has been admitted by the court that the rule is severe which is deliberately designed to operate in a draconian and deterrent fashion,[374] it could find economic justifications as opposed to the penal remedy of avoidance *ab initio*: primarily, while it could provide the incentives for the insured not to submit the fraudulent claim as is expressed by Lord Mance that: "the policy of the rule is to discourage any feeling that the genuine part of the claim can be regarded as safe and that any fraud will lead at best to an unjustified bonus and at worst, in probability , to no more than a refusal to pay a sum which was never insured in the first place",[375] a forfeiture is unlikely to be as economically ruinous as avoidance *ab initio*, since it is limited to money already paid over for the particular claim by the party against whom the forfeiture is sought. The possibility that forfeiture could bring the moral hazard problem on the part of insurer is also low, so it is a cheaper remedy for the legal system to administer.[376] In addition to forfeiture, termination seems to be a nature consequence for breach, because in the eyes of economics, the term should be treated as a condition so that additional judicial costs for the purpose of deciding the extent of breach could be avoided. Nevertheless, the decision rests on insurer in the sense that he needs to balance the economic result (the

[374] *Axa General Insurance Ltd. v Gottlieb* [2005] Lloyd's Rep.IR 369, 378 (Mance LJ)

[375] *Ibid.*

[376] Posner, *Economic Analysis of Law*, 7th edn, Wolters Kluwer (2007), 130

income of premium as such) and see whether it is worthy of continuing business with the fraudulent insured.

D. Conclusions

[5.45] In summary, from economic perspective, it can be safely suggested that the principles of contract law are capable of handling the fraudulent claims problem in insurance contracts. Express contractual approach and implied contractual approach both enable the insurer to tackle the problems in an efficient way mainly by minimizing transaction costs in negotiation and claim stages. Furthermore, the contractual approach, as opposed to avoidance *ab initio* remedy, is not likely to bring the moral hazard problem on the part of insurer and generate the ruinous economic results in the sense that the remedy may only leave the insured uncovered but will not force him to pay back all the indemnities he has received legally under the same contract.

IV. The Incentive Contractual Arrangements for the Purpose of Deterring the Fraudulent Claims

[5.46] The problem of fraudulent claims, in the contractual context, could be minimized not only by the *ex-post* remedies but also by *ex-ante* appropriate contractual arrangements. These arrangements could operate as preventive measures. In insurance contract, certain clauses or terms bear the economic function of providing incentives to the insured to acting honestly thereby deterring the fraudulent claims, and it will be the subject of deliberation in the next part in respect of what extent such clauses could influence normative behaviour of the insured.

[5.47] Contractual design may affect claiming behaviour considerably. Due to the informational asymmetry in the claiming stage, the insured is in a superior position who can opportunistically select the action suitable for his own interest. Thus, a rational insurer would response such opportunistic behaviour in the contract in the

first place and imposes the cost ex-ante on the insured. As a result, insured may have less incentive to commit fraudulent claims. Certain arrangements in insurance law bear such risk-sharing and risk-aversion economic implication. In this regard, partial insurance and bonus-malus insurance are both considered as rational choices for the purpose of risk-sharing, but the latter seems to be working better in the multi-period contractual relationships. In addition, notification of claims clause plays an important economic role to address the informational asymmetry, and if drafted properly, shall leave little room for the insured to fabricate the circumstances of losses.

A. Partial Insurance

[5.48] The main idea is that the some costs should be borne by the insured. Full insurance may not be the optimal contractual arrangements for the insurers as it simply provides the insured with no motivation to make efforts to take care of the subject-matter of insurance because all the losses will be borne by the insurer. However, partial insurance makes the insured responsible for his actions. There are two forms of partial insurance: coinsurance and insurance with deductibles.

(a) Coinsurance

[5.49] In the case of *Muirhead v Forth&North Sea Steamboat Mutual Ins Assn*[377], the stipulation in question provides that: "The sum insured on any one steamer shall not exceed £1000 or such other sum as the directors may think prudent, but in no case to exceed four-fifths of the value of such steamer including trawl gear; and it shall be a condition of this insurance that the assured shall keep one-fifth uninsured." Lord Herschell LC explained the meaning and the purpose of this clause that:

> "It seems to me to be impossible to put any other construction upon those words than this, that he shall be his own insurer to the extent of one-fifth, so as to secure due attention and care on his part."[378]

[377] [1894] AC 72

[378] *Ibid.*, 77

[5.50] Another example is the case of *General Ins Co of Trieste v Cory*[379]. The action is on the policy of reinsurance of the risk on the ship, the plaintiffs having paid the owner in respect of a total loss on the original policy. In the original policy the value of the ship was stated to be £12,000, and the ship was covered by insurances to the amount of £9600; and the policy contained the clause, "Warranted £2400. Uninsured." Mathew J stated that:

> "The meaning of this clause is perfectly plain: the owner was to be his own insurer to that amount, and to the extent of £2400, therefore, the owner was as interested as were the underwriters in the safety of the ship."[380]

[5.51] The underlying economic design here is that risk should be fairly allocated between insured and insurer. Take the first case as an example, the more amount of loss being suffered or fraudulently claimed by insured, the more expenses will be allocated to or undertaken by him (let alone that he needs to run the risk of being caught), which gives him further motivations to prevent or reduce the loss or avoid substantial dishonest claims.

(b) Insurance with deductibles

[5.52] Insurance policies usually contain a provision referred to as deductible clause or excess clause, whereby the insured have to bear the first part of any loss, usually expressed by way of a specific amount or percentage. This first layer of the loss is called deductibles and claims below or equal the deductibles are eliminated; all sums above the amount of excess, up to the limits of the policy, are within the scope of the cover. For the purpose of this particular clause, the insured is regarded as the his own insurer for that sum deducted, and the position is regarded in law as creating a

---

[379] [1897] 1 QB 335

[380] *Ibid.*, 338

primary layer of cover consisting of the deductibles and a second layer of cover consisting of insurance itself.[381]

[5.53] The excess or deductible clause is different from the franchise clause. They both stipulate a minimum figure that triggers the insurer's liability but the under the franchise clause, once the amount of loss exceeds that minimum figure, the insurer is liable for all the amount of losses without any deduction.[382] It may be said that excess clause is an absolutely deductible clause but franchise clause is a relatively deductible clause.[383]

[5.54] The calculation of precise deductibles as to individual insurance contract is a pure actuarial work. Deductible indeed could help the insurers to spread the risk of moral hazard but this does not lead the conclusion that higher deductibles could bring about lower possibility of presentation of fraudulent claims. In the case of exaggeration of insurance claims, recent survey research has indicated that when insureds attempt to justify the practice of inflation, they often rationalize it as necessary to recover perceived losses or expenditures due to unused premium payments or contracted deductibles. Inflation of claims amounts to help cover a deductible was seen by the insured to be the most accepted type of insurance fraud.[384]

---

[381] Merkin, R, *Colinvaux & Merkin's Insurance Contract Law* (loose-leaf), Sweet&Maxwell (2007), C-0156

[382] *Paterson v Harris* (1861) 1 B&S 336. A typical franchise clause (Institute Time Clauses Freight Cl.12; Institute Voyage Clauses Freight Cl.10) provides that:
"This insurance does not cover partial loss, other than general average loss, under 3% unless caused by fire, sinking, stranding or collision with another vessel. Each craft and/or lighter to be deemed a separate insurance if required by the assured"

[383] Sometimes franchise clause is called disappearing deductible clause. Bennett,C, *Dictionary of Insurance*,2nd edn, Prentice (2004), 115

[384] Tennyson, *Insurance Experience and consumer's attitudes toward insurance fraud*, Journal of Insurance Regulation 21 (2), 35-55. Although the conclusion comes from the consumer insurance, but there is no firm reason against the conclusion being applied in the context of commercial insurance.

A possible reason for this finding may be that people want to be completely reimbursed for all losses in an insurance relationship. These findings have produced the question as to whether higher deductibles would lead to even greater feelings of justification for exaggeration of claims as opposed to lower deductibles. An empirical sociological-economic research demonstrates that the answer may be related to ethicality of the insured: for insured with less stringent ethical beliefs, an incident of inflation of insurance claims will be seen as less unethical, fairer to insureds and will result in a higher proposed monetary claim award when the deductible in the insurance contract is high than it is low. For insureds with more stringent ethical beliefs, the effects of deductible amount will have less or no effect.[385]In short, it is submitted that deductible size negatively influences perceptions of the ethicality and fairness of the insurance arrangement and therefore increases the acceptability of inflation of claims. This conclusion was supported by a market investigation in Canada that in the Canadian auto insurance industry, a deductible increasing from $250 to $500 increases the average claim by 14.6%-31.8% (from $628 to $812).[386]

B. Bonus-Malus Insurance

[5.55] In the introductory part of the thesis, it has been discussed that in order to decide the appropriate premium which can reflect the corresponding risk, the insurer will usually gather the insureds with the similar risks together and offer them the same premium. However, it is obvious that such classification is not able to take all the influential factors into account, so that variables and differentials still remained within the risk group. Therefore, a fixed premium system might be too rigid to reflect the real risk of the insured. Since these differentials will be reflected in the course of time by the claim experience of each risk, the insurers may come to a fairer conclusion by adjusting the base premium according to the individual claim experience of the risk.

---

[385] Miyazaki, *Perceived Ethicality of Insurance Claim Fraud: Do Higher Deductibles Lead to Lower Ethical Standards*, Journal of Business Ethics (2009) 87: 589-598

[386] Dionne & Gagné, *Deductible Contracts against Fraudulent Claims: Evidence from Automobile Insurance*, Review of Economics and Statistics 83: 290-301.

[5.56] Bonus-Malus Insurance contract is designed for this purpose. Bonus-Malus is a Latin word for "good-bad", and this type of insurance contract records good and bad events in insured's history: premiums go up when insured have a circumstance that is "bad"; likewise, "good" situations will reduce insured's premiums. That is to say, in a multi-period setting, whenever a claim is presented, increase is then made in the subsequent premiums. If there is no claim being made in the current period of insurance contract, when renewing the contract, the insured will get the premium discount. This strategy is also referred to as experience rating mechanism, which could be used to tackle the submissions of fraudulent claims because it is obvious that if an insured's future premiums are increased whenever a claim is presented, there exists a direct incentive against the presentation of fraudulent claims.[387]

C. The economic functions of notification clauses

[5.57] Fraud may not always be premeditated, so after the happening of loss the insured inevitably requires time to plan and prepare fraudulent documents to support the claim. The economic function of notification is to address such information asymmetry and provide incentives to the insured to act promptly. Although the drafting may vary, the purpose of the notification clauses is the same: requiring the insured to report the incidents immediately to the insurer so that proper investigation and evaluation of the case can be commenced.[388] The word "immediate notice"[389] or

---

[387] A recent detailed and helpful experimental investigation was conducted in order to test the effect of Bonus-Malus insurance contractual design. See Lammers, F & Schiller, J, *Contract Design and Insurance Fraud: an Experimental Investigation*, FZID Discussion Paper No. 19/2010, available at https://fzid.uni-hohenheim.de/71978.html, accessed on 6th April 2012.The conclusion of this experiment is bonus-malus contract type seems to be a preferable choice to reduce the extent of fraudulent claims rather than deductible contracts.

[388] The test for whether notification should be made was objective not subjective. Whether notification should have been made is dependent on whether a reasonable person would have considered a claim likely to arise from the circumstances in question. See *Loyaltrend v Brit* [2010] EWHC 425 (Comm)

[389] Lloyd's Marine Policy Form (MAR 91). "Immediate" will not be judicially interpreted in its strict sense, namely, excluding any intervening time. It has almost invariably been held to mean

similar phrase will usually be contained in the clause, thus leaving little time to the insured to fabricate the facts of the loss. In *Re Williams and Thomas and The Lancashire and Yorkshire Co*,[390] it was even held by the court that, if the contract requires "notice immediately", it must be complied even if the circumstances preventing the giving of notice is beyond the control of the insured. The clauses usually also introduce a time bar which requires the notice to be given within certain periods.

[5.58] If drafted clearly, the clause will provide incentives to the insured to act without delay. For instance, the clause could be drafted as a condition precedent to the liability of the insurer.[391] In general, a condition precedent must be strictly complied with.[392] Failure of the insured to ensure the notice to be given in the prescribe way would result in the underwriter being discharging from the liability for the loss or damage arising out of that specific event. Insurer should be very careful with the drafting: if the consequence of breach is not specified in the clause, it is possible that the clause will be treated as mere conditions which bear no legal significance, breach of which only entitles the insurer to damage in so far as they can show loss.[393]

"forthwith", namely, with speedy and prompt action and as quickly as is reasonable possible. See Greenberg, D, *Stroud's Judicial Dictionary of Words and Phrases*, 7th edn, Sweet&Maxwell(2008)

[390] (1902) 19 TLR 82

[391] ITHC 1995, Clause 13. The effect of the notification clause should be in the context of the whole policy. In *Aspen v Pectel* [2008] EWHC 2804 (Comm), the insurance contract contained the following notification clause concerning claims procedure: "The Assured shall give to [the insurers' brokers] immediate written notice with full particulars of any occurrence which may give rise to indemnity under this insurance". Condition 13 of the insurance provided as follows: "The liability of Underwriters shall be conditional on the assured paying in full the premium demanded and observing the terms and conditions of this insurance." It was held by the High Court that the notification clause was, as a result of the general wording of condition 13, a condition precedent to insurer's liability for the claim.

[392] Lowry, J & Rawlings, P & Merkin, R, *Insurance Law: Doctrines and Principles*, 3rd edn, Hart Publishing (2011), 301

[393] Dunt, J, *Marine Cargo Insurance*, LLP (2009), 13.2-13.3. See also, *Friends Provident Life & Pensions Ltd v Sirius International Insurance* [2005] 2 Lloyd's Rep.517

[5.59] The incentives provided by notification clause to the insured are well-summarized by a commercial law firm Herbert Smith to its clients:[394]

> "Where notification is an issue, insurers will probably request and obtain full disclosure of the policyholder's records and/or those of its agents...The policyholder must ensure that it notifies its insurer immediately of any circumstance which occurs in both liability and property policies. It is best to be cautious and notify, even if the circumstance does not come to anything...In order to avoid any doubt as to whether notification was given, it is advisable for the policyholder to seek confirmation that its notification has been received and accepted as such."

[394] Herbert Smith, *Insurance and reinsurance litigation Bulletin*, 1 April 2010, available at www.hebertsmith.com , accessed on 6th April 2012

CHAPTER SIX

THE EVALUATION ON LAW COMMISSIONS' PROPOSED REFORMS OF THE LAW OF INSURERS' REMEDIES FOR FRAUD

Truth is mighty and will prevail

——Mark Twain

I. Background

[6.1] The proposal of reforming the insurance contract law is not a recent phenomenon. Almost three decades ago, the Law Commissions have contributed a preliminary sketch of the reform and published a Report entitled *Insurance Law: Non-disclosure and Breach of Warranty.*[1] Although it was regarded by Lord Justice Longmore as "one of the milestones in the 20th century development of the law of insurance"[2], regrettably, the recommendations derived from 1980's report were not implemented at all.

The House of Lords' decision in *The Star Sea*[3] was instrumental in demonstrating the shortcomings of the current legal regime. The law is regarded as outdated and disconnected with the current social attitudes and economic status. The Law Commissioner Mr David Hertzell said: "we cannot just assume that 300 years of tradition and a set of nineteenth-century rules codified primarily from the marine

---

[1] The Law Commission, Law Com No.104 (1980), available at http://www.peterjtyldesley.com/files/Cmnd_8064_Insurance%20Law_Non-Disclosure_and_Breach_of_Warranty.pdf, accessed on 6th April 2012

[2] Longmore, *An Insurance Contracts Act for a New Century?* [2001] LMCLQ 356, 357

[3] [2001] 1 Lloyd's Rep.389

market is entirely appropriate for a global industry in the twenty-first century."[4] The pressure for another reform continued to mount immensely.

Finally, almost 26 years after the previous report, in January 2006, English Law Commission in conjunctive work with Scottish Law Commission decided to launch a wide range reform program intending to research the difficulties in the current system and propose the solutions accordingly. In the Scoping Paper published in the same year, the law relating to fraudulent claims was identified as a potential area deserving further analysis not only because fraud is a major concern for insurers but also because the insured needs clarification as to the scope and the consequence of fraud.[5] In July 2010, the Law Commissions published an Issues Paper named *The Insured's Post-Contract Duty of Good Faith*[6] which essentially concerns insured's duty not to make a fraudulent claim. At the end of Issues Paper, the Law Commissions proposed 15 consultation questions mainly in respect of the remedies for fraudulent claim and asked for comments and responses. Based on the comments received, in December 2011, a joint Consultation Paper calling for review entitled *Insurance Contract Law: Post Contract Duties and Other Issues*[7] was published and Chapter 2 of the Paper is devoted to the issues of Insurers' Remedies for Fraudulent Claims. The intention of the Law Commissions is to develop their proposal and draft the legislation on the basis of reviews received in 2013.

---

[4] Hertzell, D, *Insurance Contract Law Reform in England/Wales and Scotland*, Chapter 1 of *Reforming Marine and Commercial Insurance law*, Soyer, B (Ed), Informa (2008), 2

[5] Law Commissions, *Insurance Contract Law, a Joint Scoping Paper* (January 2006) 2.43-2.48, available at http://lawcommission.justice.gov.uk/docs/ICL_Scoping_Paper.pdf, accessed on 6th April 2012

[6] This will be referred to as Issues Paper below, available at http://lawcommission.justice.gov.uk/docs/ICL_Scoping_Paper.pdf, accessed on 6th April 2012

[7] The Law Commission Consultation Paper No.201 and The Scottish Law Commission Discussion Paper No.152, This is the second Consultation Paper published in the process of insurance law project, which will be referred to as Consultation Paper below, available at http://lawcommission.justice.gov.uk/docs/cp201_ICL_post_contract_duties.pdf, accessed on 6th April 2012

[6.2] In the previous chapters of the thesis, the current legal propositions regarding fraudulent claims have been extensively analyzed and a corresponding economic analysis has also been provided for the purpose of justifying the conclusions made in legal analysis. The purpose of this chapter is to comment on the Law Commissions' proposal on the subject and to test whether they contribute to the previous analysis in the thesis.

II. Preliminary Considerations of the Reform

[6.3] It is certainly a fair observation to say that the current law on fraudulent claim jurisdiction is "convoluted and confused".[8] The Law Commissions also correctly admit that the central problem is the mismatch between the common law rule and the duty of good faith.[9] Therefore, the first preliminary issue for the Law Commissions to solve is how to harmonize this mismatch. Basically, the Law Commissions can either choose to reform the common law rule or the duty of good faith derived from Section 17 of the Marine Insurance Act 1906 to achieve this purpose.

In Chapter Four, it has been concluded that the reform of Section 17 will be radically disturbing the certainty of law and is, therefore, not recommendable.[10] Moreover, in Chapter Five from perspective of economics, it has also been concluded that the reform of Section 17 will be economically inefficient and is, therefore, not recommendable too.[11] It seems that the Law Commissions are in line with the findings of this thesis: they have adopted a more direct approach and are not considering the possibility of reforming Section 17 in the post-contractual context at

[8] Consultation Paper 6.1. See the detailed analysis regarding this confusion in Chapter Four of this thesis.

[9] Consultation Paper 6.11. There is a serious illogical mismatch in this regard if two remedies co-exist, as Law Commissions pointed out: "it is one thing to say that only fraud breaches the insured's post-contract duty of good faith. It is another thing altogether to say that even fraud does not breach the duty." Consultation Paper 6.44

[10] Chapter Four, at [4.154]-[4.156]

[11] Chapter Five, at [5.25]-[5.29]

all. They simply say the current remedy provided Section 17, namely avoidance, is unprincipled, impractical and unnecessary harsh and therefore should be replaced.[12]

[6.4] The second preliminary issue for the Law Commissions to determine is whether it will be helpful to conduct a legislative reform on this point.[13] It shall always be borne in mind that any suggestion to start a proposal of statutory reform shall be proceeded prudently and discreetly not only because the process of legislating is complicated and costly but also because that the reform may involve a significant legal change to the market in which there are well-established and widely-accepted business practices.[14] However, it seems the problem shall not be overstated here. First of all, the Law Commissions' proposal is not a "sweeping reform which would change all parameters of underwriting practice"[15] but only a modification or a cure to the defects and uncertainties in the current legal practice. The mainstream is clearly well-established by judicial authorities, namely insured who commits fraud forfeits the whole claim, but it is unsettled as to the effect of fraud on other claims made under the policy.[16] The Law Commissions have correctly identified three unresolved issues in the current legal practice: (a) Does a fraudulent claim affect a previous claim made under the same policy? (b) Does a fraudulent claim affect subsequent claims made before the insurer has taken action to terminate the contract? (c) May the insurer sue the insured for damages to recover the cost of investigating a fraudulent claim?[17] They have concluded that the proposed reform would uphold the existing case law by clarifying that avoidance is not the appropriate remedy for want of good faith during the currency of contract.[18] The reform is not a substantial change to the current law,

[12] Consultation Paper 7.10-7.16

[13] Issues Paper 7.5

[14] Bakes, M, *Pre-Contractual Information Duties and the Law Commissions' Review*, Chapter 2 of *Reforming Marine and Commercial Insurance law*, Soyer, B (Ed), Informa (2008), 63

[15] Soyer, B, *Reforming Insurance Warranties-Are We Finally Moving Forward?*, Chapter 7 of *Reforming Marine and Commercial Insurance law*, Soyer, B (Ed), Informa (2008), 133

[16] Consultation Paper 6.1

[17] Consultation Paper 6.60

[18] Consultation Paper 7.56

so it is unlikely that the reform as to those relatively narrow issues would introduce new legal concepts and lead to the change of current market practice.

Lord Justice Rix once suggested that: "the common law should not be afraid of moulding its own remedies where at any rate statute gives it room to do so. The common law's ability to mould a proper principled response to individual circumstances is part of its genius".[19] Indeed, common law could not have such a dynamic life in modern era if great judges had not from time to time keenly perceived the social change and boldly laid down new rules to meet the problems, but English court did not do a good job in moulding the proper remedy for fraudulent claims. To start with, the courts have been inconsistent, confused and have left much uncertainty in this area. For example, in *The Star Sea*, the House of Lords just held that the defendants' case failed on the facts of the case and left the complicated legal issue open for further discussion.[20] Later in *The Mercandian Continent*, Longmore LJ's convoluted reasoning made the issues more uncertain and unnecessarily complicated.[21] Then, although in *Agapitos v Agnew*[22] Mance LJ was of the opinion that avoidance was not the proper remedy against fraudulent claims, the suggestion was no more than a *obiter dictum* and did not have binding authorities at all. Secondly, it is noteworthy that the principal responsibility of the court is to decide the cases by applying the law to the particular facts of the case as found, which means that the judicial reform is basically in a piecemeal and the systematic reform can only be achieved over a long period of time. Thirdly, for law to be developed by judges there is a need for good fortune. Lord Justice Aikens once said: "But how long will we have

---

[19] Lord Justice Rix's speech at the British Insurance Law Association President's lunch on 19 December 2001, cited by Bakes, M, *Pre-Contractual Information Duties and the Law Commissions' Review*, Chapter 2 of *Reforming Marine and Commercial Insurance law*, Soyer, B (Ed), Informa (2008), 63

[20] [2001] 1 Lloyd's Rep.389, 391,405, 406, 410.Their Lordships held that for the defendants to succeed in their defence under s. 17 they had to show that the claim was made fraudulently; and they had failed to obtain a finding of fraud. This judgement left the possibility that Section 17 still has the room to be applicable in this area.

[21] [2001] 2 Lloyd's Rep.563 (CA). See the critical discussion in this regard in Chapter Four, at [4.114]-[4.119]

[22] [2002] 2 Lloyd's Rep.42

to wait for the right case to get to the Supreme Court, and then will it bit the bullet?"[23] In brief, a legislative reform seems to be more appropriate in this unfruitful field.[24]

[6.5] The third preliminary issue for the Law Commissions to decide is the scope of reform. The main question is that besides the remedy issue, whether the definition of fraud shall be statutory regulated. In this regard, it is correct for the Law Commissions to propose that the definition of fraud shall not be statutorily confined and shall be left to the common law, and the main justification is that fraud is itself a malleable and evolving concept so flexibility shall be left to the court pursuant to the factual matrix of the particular case. Support of this proposition could be found in the development of case laws in the last decade. For example, the position of the use of fraudulent means or devices in making a legitimate insurance claim was not fully clarified until Mance LJ (as he then was) delivered the judgement in *Agapitos v Agnew*,[25] which confirmed that fraudulent means being a sub-species of making a fraudulent claim. Furthermore, in two very recent cases of *Goldsmith Williams (A Firm) v Travelers Insurance Co Ltd*[26] and *Aviva Insurance Ltd v Roger George Brown*,[27] both Wyn William J and Eder J, linking the concept of fraud with the concept of dishonesty and applying the test established in the case of *Twinsectra Ltd v Yardley*,[28] concluded that in order to establish dishonesty or fraud, in addition to the dishonest conduct, the state of mind of the party in question shall also be taken into account. That is to say, it requires "more than knowledge of the facts which make the conduct wrongful" and indeed "consciousness that one is transgressing ordinary standards of honest

---

[23] Aikens, *The post-contract duty of good faith in insurance contracts: is there a problem that needs a solution?* [2010] JBL 379, 392

[24] Lord Reid observed that the courts certainly had an important function in the adaptation of law to new circumstances, but that they could not assume the function of Parliament in matters of general policy. See *Pettit v Pettit* [1969] 2 ALL ER 385, 390. It is submitted that fraud issue is indeed such matters of general policy.

[25] [2002] 2 Lloyd's Rep.42

[26] [2010] Lloyd's Rep. IR.309

[27] [2011] EWHC 362 (QB)

[28] [2002] 2 AC 164

behaviour".[29] Particularly in the case of *Aviva*, many allegations were submitted that the learned judge carefully applied the test in each of them and concluded that in respect of some of them the defendant did not realize that he has committed fraud so the allegations failed.[30]

Those judicial observations all proved that fraud is a concept that needs to be evolved to adopt the change in commercial practice. Thus, a rigid statutory definition is indeed not necessary and flexibility should be awarded to the court to accommodate the potential growth of the definition of fraud.[31]

[6.6] The fourth preliminary issue for the Law Commissions to decide is the form of the regime that is going to be adopted. In other words, whether the proposed statute shall be mandatory (mandatory regime) or can be superseded by the express agreement reached by parties (default regime).

The Law Commissions is clearly of the opinion that commercial insurance contracts should be based on freedom of contract where possible.[32] In the light of the previous analysis of this thesis, this is the right starting point, in the sense that freedom of contract is not only a fundamental value of commercial law[33] but also terms agreed on the basis of it is economically efficient.[34] Therefore, the Law Commissions propose that an express fraudulent clause should be upheld, but only if it is written in clear unambiguous terms and specifically brought to the attention of the other party.[35] In other words, the statutory provision is a default regime and can be changed by express agreement of the parties, but the change is subject to two safeguards in order to control of abuse of freedom of contract: incorporation and interpretation.

---

[29] *Ibid.* [20] (Lord Hoffmann)

[30] Chapter One, at [1.3] and Chapter Two, at [2.37]

[31] The current law regarding the general definition of fraud has been evaluated in the Chapter One.

[32] Consultation Paper 1.41, 7.41

[33] Chapter Four, [4.14]

[34] Chapter Five, [5.35]-[5.40]

[35] Consultation Paper 8.25

First of all, express fraudulent clause is seemingly treated by the Law Commissions as a kind of onerous or unusual terms in the context of general contract law so special measures may be required fairly to bring it to the notice of the other party,[36] as Lord Denning famously suggested that: "in order to give sufficient notice, it would need to be printed in red ink with a red hand pointing to it, or something equally startling." [37] Otherwise, the term will not be incorporated into the contract. One may argue that since the fraudulent clause can be found in many insurance contracts, it can hardly say that the term is onerous or unusual. However, in the case of *O'Brien v MGN Ltd*,[38] Hale LJ stated that: "the words 'onerous or unusual' are not terms of art. They are simply one way of putting the general proposition that reasonable steps must be taken to draw the particular term in question to the notice of those who are bound by it and that more is required in relation to certain terms than to others depending on their effect." Therefore, it seems the question of incorporation will be ultimately dependent upon the effect of the term in question. In the light of the Law Commissions' Proposal, express fraudulent clause can be used to extend the remedy for fraud, e.g. avoidance of the contract or reduce the sanctions against fraud.[39] To this extent, it may be argued that the effect of the clause is indeed not usual and higher standard test for incorporation shall be satisfied.[40] Therefore, according to the Law Commissions' proposal, it is better in practice for both insurer (in the situation where the remedy is extended) and insured (in the situation where the

[36] Beatson, J & Burrows, A & Cartwright, J, *Anson's Law of Contract*, 29th edn, Oxford (2010), 176

[37] *J Spurling Ltd v Bradshaw* [1956] 1 WLR 461, 466

[38] [2001] EWCA Civ 1279, [23]

[39] Consultation Paper 8.25-8.26

[40] In English contract law, in consideration of contractual certainty, there is a rule saying that when a document is signed then in the absence of fraud and misrepresentation, the party signing it is bound. See *L' Estrange v E.Graucob Ltd* [1934] 2 KB 394, 403 (Scrutton LJ). A problem may then arise as to the position where an alleged onerous or unusual term in a signed document which has not been sufficiently brought to the other's attention before signature. This problem was considered in *Ocean Chemical Transport Inc v Exnor Craggs Ltd* [2000] 1 ALL ER (Comm) 519, [48], where Evans LJ was in the opinion that the higher standard for incorporation would only be applicable in extreme cases where a signature was obtained under pressure of time or other circumstances and where the clause was particularly onerous or unusual in relation to the contract. This judgement gave a warning that parties shall think over before they sign the contract.

remedy is reduced) to present the term in large size print or bold print or be placed in a box in the document. This proposal is sound and reasonable.

Secondly, given the freedom of contract is the fundamental value then the starting point of interpretation must be words which the parties have chosen to use, and the task of the court is simply to conclude the meaning of words against the relevant background. The court must play a conservative role when performing the task and should not try to rewrite the contract for the parties. It is quite true that "in the field of commerce, where the parties need to know what they must do and what they can insist on not doing, it is essential for them to be confident that they can rely on the court to enforce their contract according to its terms",[41] but this proposition is established upon the basis that the words used by parties are clear and unambiguous. The courts has to construe the clear and unambiguous contractual drafts as they stand even though the result might not be inappropriate or even unfair for one party of the contract. This is the reason for enforcing a clause stipulating that in the event of fraud the insurer may avoid the policy from the inception of the insurance.[42] If the draft is vague, the court will construe it against the party who proposed it for inclusion in the contract.[43] Again, the Law Commissions' proposal that a clause that changes the statutory remedies should be written in clear and unambiguous terms is in conformity with the general interpretation principles of contract and, therefore, is logical and rational.

Finally, it has been clearly held that, on the grounds of public policy, a clause in insurance contract excluding the liability of fraud on the part of the insured himself is not valid,[44] but the question as to the validity of a clause excluding the fraud liability on the part of insured's agent was left open by the House of Lords. Nevertheless, the Law Commissions' view is that this kind of clause would be rare in the practice and even if it exists, crystal clear words shall be employed in order to give the effect to

[41] *Charter Reinsurance Co Ltd v Fagan* [1997] AC 313, 388 (Lord Mustill)

[42] Consultation Paper 6.18-6.20. See *Joseph Fielding Properties v Aviva Insurance* [2011] Lloyd's Rep IR 238, Chapter Four ,at [4.24]

[43] *Youell v Bland Welch & Co Ltd* [1992] 2 Lloyd's Rep.127, 134 (Staughton LJ). See Chapter Four, at [4.28]

[44] *HIH Casualty & General Insurance v Chase Manhattan Bank* [2003] 2 Lloyd's Rep.61, [15]-[16] (Lord Bingham)

it.[45] It seems no serious doubt could be cast upon this position and court is a much better place to solve this issue, so it is appropriate that no legislative attempt is made to regulate this issue.

III. Analysis on the Law Commissions' Proposed Statutory Provision

[6.7] In the absence of the express fraudulent claim clause, the Law Commissions provisionally proposes that the statutory provision shall be provided as follows:[46]

> (1)A policyholder who commits a fraud in relation to a claim forfeits the whole claim to which the fraud relates. Any interim payments made in respect of the claim must be repaid.
>
> (2)The policyholder also forfeits any claim which arises after the date of the fraud.
>
> (3)The fraud does not affect any previous valid claim where the loss arises before the fraud takes place, whether or not the claim has been paid.
>
> (4)The insurer has a right to claim the costs reasonably and actually incurred in investigating the claim, provided that the insurer has not already received recompense for these costs through the first and second remedies.

This provision is the core of the reform and needs to be further analyzed.

A. Forfeiture of the whole claim to which the fraud relates

[6.8] This provision is no more than a statutory confirmation of the common law position derived from a series of cases in particular *Axa General Insurance Ltd v Gottlieb*[47] which has been discussed in very details in Chapter Four. The principles established are sound and reasonable. The only unclear point in this regard is the meaning of "the whole claim".

[45] Consultation Paper 7.51. See also, Chapter One, at [1.22]

[46] Consultation Paper 8.6

[47] [2005] Lloyd's Rep.IR 369

Mr Rhys Clift from Hill Dickinson suggested that "where there are losses of two insured types resulting from one operation of an insured peril, and fraud is committed in relation to the claim for one of the two losses, the claim in respect of the other loss also will be forfeited."[48] He then gave the illustration that "if damage to a ship on a voyage results both in a claim for salvage to bring the vessel from the place where the damage occurred to a place of safety, and in a claim for the cost of repairs, and there is a fraud committed in relation to the claim for repairs, then the insurers will be entitled to recover back from the insured whatever amount they may have paid in respect of the salvage claim."[49] It seems that although the principle provided by Mr Clift makes sense, his illustration goes a bit far away from the current legal authorities. Comparison could be made with the example given by the Law Commissions in *Aviva Insurance v Brown.*[50] In the latter case, due to the subsidence of his house, the insured had to find alternative accommodation. He then made two claims requesting for indemnity of the cost for repairing the subsidence and the cost of alternative accommodations. Insurer successfully proved that the second claim was fraudulent and the court ruled in insurer's favour to the effect that both claims should be forfeited. Two claims are arising out of the same peril and the connection between them is very close.[51] But in Mr Clift's example, although the salvage claim and repair claim (hull claim) are arising out of the same accident, they are completely separate, e.g. under the standard Institute Hull Clause 1983 version two claims are governed by separate clauses, so it is far from persuasive in this situation why fraud in relation to one will make the other forfeited.

The Law Commissions have noticed that at this stage the court is apt to give a broad definition on the meaning of "the whole claim" and the Law Commissions decided not to legislatively interfere in the matter. It seems that the Law Commissions are justified to introduce a certain degree of flexibility in this area. The current view from the court seems a bit harsh but it is for the policy purpose of deterrence of the

[48] Rhys Clift, *Fraudulent Insurance Claims*, 6.17, available on i-law and http://www.hilldickinson.com, accessed on 6th April 2012

[49] *Ibid.*, 6.18

[50] [2011] EWHC 362 (QB), Consultation Paper 8.9

[51] The words used by Law Commissions indeed suggest that two claims are inter-related: "the policyholder for subsidence to his home, which led him to seek alternative accommodation…"

fraud. In the long run, if it is observed that the rule goes against the insured too much, in the light of the facts of cases and the terms of contract in question, it is open to the judges to make some adjustments correspondently and adopt a narrow notion of "the whole claim" accordingly.

[6.9] Moreover, it should be noted that it is possibly not open for the insured to argue that the forfeiture of the whole claim tainted by fraud could be estopped because estoppel is an equitable remedy, and only those who come with clean hands are allowed to benefit from it.[52] It is also on that principle appropriate to expect the insured to repay any interim payment made in relation to the claim.[53]

B. Forfeiture of subsequent claims

[6.10] The sub-section (2) of the proposed statute is the one of the significant reform suggested by the Law Commissions, where the uncertainty about the effect of a fraud on the subsequent claims is eliminated. The reasoning for the Law Commissions to introduce this provision and its potential legal implications may be evaluated as follows:

[6.11] The Law Commissions proceed on the premise that submission of fraudulent claims destroys the foundation of insurance contractual relationship, namely good faith, and therefore shall be regarded as repudiatory. However, in the light of general contract law, repudiation by guilty party discharges the aggrieved party from the further performance of the contract, that is to say, contract terminates accordingly. Termination does not happen automatically since the innocent party has the right to choose whether to treat the contract as still continuing or accept the breach and terminate the contract. The acceptance, usually in the form of communication or conduct, by aggrieved party must clearly and unequivocally convey to the repudiating

---

[52] See Below, at [6.13]

[53] *AXA General Insurance Ltd v Gottlieb*[2005] Lloyd's Rep.IR 369. See Chapter Four, at [4.6]-[4.8]. Interim payment cannot be regarded as estoppel.

party that he is treating the contract as at an end.[54] Inevitably, there will be a time gap between the date of fraud and the dates on which the insurer discovers the fraud and terminates the contract. It is not impossible that innocent claims will arise during this period and it is not clear whether those claims will be regarded as valid. In the Issues Paper, the Law Commissions put forward that fraud does not automatically bring the contract to an end and therefore any claims arising between the date of the fraud and the date of the termination must be paid,[55] with which most insurers and practitioners disagreed. Broadly speaking, the proposal raised by the Law Commissions in the Issues Paper clearly shows that the Law Commissions are inclined to cure the problems by moving insurance contract law into the line with general contract law. However, Lord Justice Aikens, when commenting on the Law Commissions' reform proposal on warranties, advocated that such a stance should be avoided: [56]

> "a move towards assimilation with the general law of contract may obscure the principal difference between a contract of insurance and most other types of contract, which is that the former is a contract of utmost good faith...I would urge reformers to think carefully before adopting proposals that might unsettle this basic principles."

It seems that the Law Commissions have found a way to emphasis the significance role of good faith in insurance contracts but at the same time not to deviate from the normal contractual approach: on the one hand, if the insurer wants to terminate the contract, he is still required to exercise the option and communicate his decision to insured; on the other hand, as fraud on the part of insured destroys the basis of the insurance contract, the insurer is allowed to discharge himself from liability for any loss which takes place after the date of the fraudulent act. In essence, it seems that the Law Commissions seem to suggest that the requirement that insured refrains from fraud should be a statutory condition precedent to insurer's all subsequent liability to the losses after the fraud.

Nevertheless, some conceptual confusion may still exist in the Law Commissions' suggestions. It seems at the first sight that the consequence of

---

[54] *Vitol SA v Norelf Ltd* [1996] AC 800, 810-811

[55] Consultation Paper 4.58-4.59

[56] Aikens, *Law Commissionss' Proposed Reforms of the Law of "Warranties"*, Chapter 5 of *Reforming Marine and Commercial Insurance law*, Soyer, B(Ed), Informa (2008), 125

forfeiture of any claim which arises after the date of the fraud is as effective as the consequence of breach a warranty requiring insured not to commit fraud, however, some slight differences still can be raised.[57] In the case of breach of warranty, the insurer is automatically discharged from all the liability as from the date of the breach of warranty, but in the case of breach of this statutory condition precedent, the insurer is only discharged from the liability as to the subsequent losses and claims. That is to say, theoretically, the insurer is still responsible for other liabilities under the contract until he has exercised his option to treat the insurance contract as an end, although practically there may not be much difference between two consequences. In addition, since the policy remains intact after the fraud, the obligations of the insured under the contract still survive, e.g. he still has a continuing liability to pay a premium. This consequence closely resembles that of breach of warranty.[58]

[6.12] The second reason supporting the proposition that fraud forfeits the subsequent innocent claims is: due to the common fact that a fraud investigation may take considerable time, a rule that requires the insurer to take action to terminate the contract immediately would encourage premature allegations of fraud without fully investigating it. This reason may be particularly justifiable and significant when considered in the context of the Law Commissions' another reform proposal on damages for late payment of claim, which deserves some explanations in the passing lines for the current purpose.[59]

The problem of damages for insurer's late payment of claim has been haunting English insurance contract law for a long time. The current anomalous rule is that if

[57] In *The Good Luck* [1992] 1 AC 233, 262-263, Lord Goff, referring the wording of Section 33 (3) of the Marine Insurance Act 1906, commented that: "...if the promissory warranty is not complied with, the insurer is discharged from liability as from the date of the breach of warranty, for the simple reason that fulfilment of the warranty is a condition precedent to the liability or further liability of the insurer." It seems that Lord Goff did not intend to differentiate the concept of condition precedent of warranty in an irreconcilable way. See the observations made by Soyer, B in *Warranties in Marine Insurance*, 2nd edn, Cavendish Publishing, 144-145

[58] *The Good Luck* [1992] 1 AC 233, 263 (Lord Goff)

[59] A full account of the reform regarding damages for late payment, see Consultation Paper 2.1-5.56

the insurer fails to pay a claim timely or in accordance with the terms of insurance contract, the remedy of the insured is confined to the indemnity pursuant to the insurance contract plus the statutory interest, which means that insured is not entitled to claim any loss caused by insurer's delay or failure to pay a claim. This proposition is based upon a strange theory that insurer's primary obligation under the insurance contract is not to pay valid claims but to hold the insured harmless.[60] As soon as the risk covered by the insurance contract occurs, the insurer is in breach of contract with the result that payment made under the contract is essentially damages for insurer's breach of contract. Thus, damages are not payable for non-payment or late payment of damages.[61] This surprising proposition is totally against the normal principle in contract law established in *Hadley v Baxendale*[62] and was criticised as unprincipled, unfair, and reduces the perceived fairness and competitiveness of English law, which therefore needs reform in the Law Commissions' view.[63] The tentative proposal offered by the Law Commissions is that insurer's primary obligation shall be legislatively re-categorized as the obligation to pay the valid claims after a reasonable time for the purpose of full investigation and assessment of the loss. An insurer who unreasonably delays or wrongfully repudiates a claim should be liable to pay damages for proven and foreseeable loss.[64]

It is not unlikely that a premature allegation of fraud could be a false allegation. If the allegation is not substantiated, the insurer may take the risk of being sued for wrongful repudiation of the valid claim and therefore be responsible for the consequential and foreseeable damages that may be caused by the breach. Insurer's situation in this context is very similar to the one encountered by the shipowner in time charterparty case where the charterer fails to pay the hire punctually. If the shipowner fails to follow the procedure stipulated in the contract strictly before withdrawing the ship, the withdrawal could be regarded by the charterer as repudiation of the charterparty so the charterer will be entitled to claim the consequential damages. By analogy, if the insurer fails to fully investigate the claim

[60] Consultation Paper 2.19-2.22

[61] *Sprung v Royal Insurance (UK) Ltd* [1999] 1 Lloyd's Rep. IR 111

[62] (1854) 156 ER 145

[63] Consultation Paper 4.6-4.13

[64] Consultation Paper 5.5-5.8

and carelessly refuses to pay, the refusal could be regarded by the insured as repudiation of the insurance contract so the insured will also be entitled to claim the damages according to the Law Commissions' proposal.

Therefore, the Law Commissions' proposal regarding the forfeiture of insured's subsequent claims if fraud being committed could set insurer's mind at rest and leave him in a good state for the purpose of investigating the alleged fraudulent claims.

[6.13] The Law Commissions' statutory condition precedent approach seems very harsh but it is not without limitations. The Law Commissions also suggest that, pursuant to the principle of normal contract law, the principle of waiver could be used to limit the effect of the provision in the sense that upon discovery of the fraud, insurer shall accept the breach of insured and pass his decision on to the insured as practically soon as possible, failing to do which may result the waiver of his defence to a subsequent claim.[65]

The issues of waiver in this particular context are not free from difficulties. In its general sense, waiver refers to "a forbearance from exercising a right or to an abandonment of a right".[66] It can take the form of either election or estoppel but it is not clear which is the appropriate one in the current factual matrix. The distinction between them was considered by Lord Goff in the case of *The Kanchenjuna*.[67] His Lordship admitted that there were similarities between the two concepts, e.g. an unequivocal representation is required in the first place for the purpose of proving waiver, but indeed differences exist.[68] Nevertheless, it seems that the form of the

---

[65] Consultation Paper 7.25, 8.13

[66] *The Kanchenjuna* [1990] 1 Lloyd's Rep.391, 397

[67] *Ibid.*

[68] *Ibid.*, 399, Lord Goff neatly summarized that "In the context of a contract, the principle of election applies when a state of affairs comes into existence in which one party becomes entitled to exercise a right, and has to choose whether to exercise the right or not. His election has generally to be an informed choice, made with knowledge of the facts giving rise to the right. His election once made is final; it is not dependent upon reliance on it by the other party. On the other hand, equitable estoppel requires an unequivocal representation by one party that he will not insist upon his legal rights against the other party, and such reliance by the representee as will render it

waiver is closely connected to the legal nature of the proposed provision. If the above analysis on the legal nature of the proposed statute is correct, namely statutory condition precedent, waiver can only be exercised by way of estoppel because fraud discharges all the liability of the insurer as to the future losses as from date of fraud automatically so there is no election to be made at all.[69] The judicial support for this proposition could be found in *Kosmar Villa Holidays* v. *Syndicate 1243*,[70] where it was held by the Court of Appeal that breach of a condition precedent requiring the insured to give immediate notice in writing of full particulars of any injury or damage automatically discharged the insurer from liability for the claim in question and no election by the insurer was required. The situation is almost identical to the issues of waiver of breach of marine insurance warranties after the breach is committed, where it was held by several authorities that the doctrine of waiver by election has no application.[71] Accordingly, if the insured intends to rely on the argument of waiver, he has to prove that insurer has made an unequivocal representation that he will not insist on his rights to refuse to pay the subsequent claims regarding the losses arising after the fraud; it would be inequitable to allow the insurer to resile from the representation if it is relied upon by the insured.[72]

The Law Commissions, borrowing the words of RBS Insurance, suggest that if an insurer is aware of a fraud but does nothing, this would constitute a waiver of the right to refuse subsequent claims.[73] This suggestion seems too simple to be followed. In the case of breach of warranty, Professor Baris Soyer argued that since insurer is

---

inequitable for the representor to go back upon his representation. No question arises of any particular knowledge on the part of the representor, and the estoppel may be suspensory only. Furthermore, the representation itself is different in character in the two cases. The party making his election is communicating his choice whether or not to exercise a right which has become available to him. The party to an equitable estoppel is representing that he will not in future enforce his legal rights."

[69] At Consultation Paper 8.16, Example 3, the Law Commissions said: "it is as if the insurance was automatically brought to an end in April."

[70] [2008] Lloyd's Rep IR 489

[71] See Soyer, B, *Warranties in Marine Insurance*, 2nd edn, Cavendish Publishing (2006), 6.36-6.39

[72] *HIH Casualty & General Insurance Ltd v Axa Corporate Solutions* [2002] Lloyd's Rep IR 325, [24]

[73] Consultation Paper 7.25

automatically discharged from liability so his silence or failure to act may show that he has elected to rely on the defence afforded to him and has no intention of waiving the remedy. Therefore, a representation in the form of affirmative conduct is required to establish the waiver.[74] Similarly, if the fraud automatically discharge the insurer from liabilities as to the loss after the fraud, it is difficult to hold that insurer has waived his right to reject the subsequent claims by silence or delay to act. Mere inactivity by the insurer following the fraud does not constitute waiver unless the insured can prove that he has been prejudiced by lapse of the time.[75] Positive conduct needs to be proved by insured if he wants to rely on the defence of waiver. However, the simple fact that insurer starts to deal with the subsequent claim does not in all circumstance mean that he has waived his right of rejection.[76] That all depends on, according to the full surrounding circumstance of the facts, whether insurer's act reasonably appears to the insured as an unequivocal representation that he will not rely on his right and the representation has prejudiced the insured

The insurer could reduce the risk of waiver either by inserting a non-waiver clause[77] into the contract in advance or reserving the rights after the claim.[78] In a very recent case *The Copa Casino*,[79] following the total loss of the vessel and the insured's submission of claim for indemnity, insurer sent a letter to the insured, declining the claim and saying: "[the insurer therefore] reserves the right to alter its position in light

---

[74] Soyer, B, *Warranties in Marine Insurance*, 2nd edn, Cavendish Publishing (2006), 6.45. The same argument is provided in Barlow Lyde & Gilbert LLP (Ed), *Reinsurance Practice and The Law*, Informa (2008), 41.23-41.24

[75] *Melik* v. *Norwich Union Fire Insurance Society Ltd* [1980] 1 Lloyd's Rep 523

[76] *Kosmar Villa Holidays* v. *Syndicate 1243* [2008] Lloyd's Rep IR 489, [69] (Rix LJ)

[77] A widely-drafted non-waiver clause could be found in protection and indemnity practice: "No act, omission, course of dealing, forbearance, delay or indulgence by the club in enforcing any of the club rules or any of the terms or conditions of its contracts with members nor any granting of time by the club shall prejudice or affect the rights and remedies of the club under the club rules or under such contracts, and no such matter shall be treated as any evidence of waiver of the club's rights thereunder, nor shall any waiver of any breach by member of club rules or contracts operate as a waiver of any subsequent breach thereof." See Soyer, B, *Warranties in Marine Insurance*, 2nd edn, Cavendish Publishing (2006), 6.46

[78] Consultation Paper 7.25

[79] *Argo Systems FZE v Liberty Insurance* (*The Copa Casino*) [2011] EWCA Civ 1572

of discovery of previously undisclosed information which would materially alter the facts and circumstances known. Should the assured wish to provide any additional information concerning this claim, we will review it. The foregoing is without prejudice to all the remaining terms and conditions of the policy, along with any other defenses which may be discovered after further investigation". Although the insurer did not rely upon the defence of breach of warranty for nearly seven years, the Court of Appeal, reversing the judgement of the High Court, held that this fact could not constitute a representation in the absence of special circumstances that were capable of turning silence and inaction into an unequivocal representation.[80] The important wording in the letter shall be taken into account: "The foregoing is without prejudice to all the remaining terms and conditions of the policy", which clearly indicated that insurer was reserving the right to rely on any of those remaining terms and conditions of the policy in the future if advised to do so. Therefore, the letter was not capable of being an unequivocal representation and no issues of waiver shall rise.

Last but not least, it must be carefully noted that, in the light of the decision of *Baghbadrani v Commercial Union*, [81] the court may be extremely strict in deciding whether or not waiver by estoppel could be established in the situation of fraud, because being an equitable remedy, in principle, estoppel needs to be approached by those with "clean hands". That said, it may, in any event, therefore, difficult to rely on estoppel in fraud cases.[82]

All in all, the emphasis given by Mustill LJ shall be fixed in the mind that cases of waiver turn particularly on the facts of each case.[83] Principle may not be difficult to comprehend but the judgement shall be given on each specific matter.

In conclusion, the limitation is not strong, so the remedy is still very powerful. The powerful effect of this provision could be justified in the eyes of the economic analysis conducted in Chapter Five, where it is suggested that if the punishment is

---

[80] *Ibid.*, [44]-[47] (Aiken LJ)

[81] [2000] Lloyd's Rep.IR.94. See Chapter Four at [4.108] to [4.113] for the detailed analysis of this case.

[82] *Ibid.*, 123 See also, Wilken, S & Ghaly, K, *The Law of Waiver, Variation, and Estoppel*, 3rd edn, Oxford (2012), 20.60, fn.213

[83] *Vitol SA v Esso Australia Ltd* [1989] 2 Lloyd's Rep 451, 460

strong enough, it will deter the fraud even when the insurer adopts the routine investigation strategy in order to save the costs.[84]

C. No Avoidance of previous valid claim

[6.14] In this regard, the Law Commissions' proposal is in accordance with the analysis given by this thesis in the previous chapters. Since Section 17 of Marine Insurance Act 1906 should not govern the jurisdiction of fraudulent claims and the common law rule of forfeiture plus normal contractual rule shall apply, except in the existence of clearly drafted terms in the contract, there is no reasonable justification at all to allow the fraud to have retrospective effect which can avoid the previous valid claims. A valid paid claim should not be subject to the subsequent events and then be overturned particularly in a long term policy. According to the Law Commissions, this proposal conforms to the current practice of the market and is supported by several leading insurers.[85] Therefore, it should be appropriate and persuasive. In addition, this proposal also is in line with the conclusions reached by this thesis in Chapter Four[86] and Chapter Five.[87]

D. Damages

[6.15] Under the current law confirmed in *London Assurance v Clare*,[88] the insurer cannot recover the cost of investigating the claim by way of damages. Even under the jurisdiction of Section 17 of the Marine Insurance Act1906, damages are not available either.[89] However, this case is critically evaluated in Chapter Four of this thesis,[90] and the conclusion is that the judge has not correctly interpreted the law in that case and there is indeed a possibility, albeit weak, that investigation cost can be recoverable in

---

[84] See Chapter Five, at [5.21]

[85] Consultation Paper 8.15

[86] Chapter Four ,at [4.160]

[87] Chapter Five, at [5.29]

[88] (1937) 57 LI L Rep.254

[89] *La Banque Financiere de la Cité S.A. v Westgate Insurance Co.Ltd* [1990] 2 Lloyd's Rep.377

[90] Chapter Four, at [4.71]-[4.72]

certain circumstances. It seems that Law Commissions are of the same view by stating that the insurer is entitled to claim the cost reasonably and actually incurred in the investigation the claim. However, a proviso is also added, indicating that the insurer can only recover the damages in the circumstances where he has not already received recompense for these costs through the remedy of forfeiture.

[6.16] It seems that the legal foundation for this sub-section still comes from the principles of normal contract law, where the fraudulent act of the insured is regarded as breach of contract. On the one hand, theoretically, every breach of contract entitles the injured party to damages;[91] on the other hand, damages can only be awarded to compensate for loss suffered by the innocent party and not to punish the contract-breaker.[92] The law of insurance contract certainly follows the same pattern, as Lord Mustill suggested in *Pan Atlantic* Insurance *Ltd v Pine Top Ltd* that there should be no room for a disciplinary element in the law of marine insurance. [93] Thus, the Law Commissions deliver the following suggestions. In order to establish the damages claim, the insurer has to prove all these elements (1) the policyholder committed a fraud and (2) the insurer actually incurred costs in investigating the fraud. The insurer will need to prove each expense. It would not be entitled to a standard cost or to a proportion of the costs of running the claims department, such as office overheads; and (3) the costs were reasonable and proportionate in the circumstances; and (4) the costs were not offset by any saving from legitimate, forfeited claims.[94]

[6.17] Some doubts could be cast on the Law Commissions' approach. The Finance Ombudsman Service is of the opinion that the cost of investigating claims is not

---

[91] Beatson, J & Burrows, A & Cartwright, J, *Anson's Law of Contract*, 29th edn, Oxford (2010), 533

[92] *Ibid.*, 534. Although it has been suggested in Chapter Four of this thesis that investigation costs may be awarded in the form of punitive damages, but this is not the current legal position under the English contract Law yet. The compensation function of contractual damages was recently reaffirm by the House of Lords in the case of *The Golden Victory* [2007] UKHL 12

[93] [1995] 1 AC 501, 549B-D

[94] Consultation Paper 8.22

recoverable because it is an integral part of the insurer's business.[95] However, it is debatable that if the insured does not submit fraudulent claim, the claim investigation will not be triggered then the costs will not be incurred accordingly, as the Law Commissions argues, citing the comments from Zurich, that: "these costs would not have been incurred had it not been for the deceitful actions of the policyholder".[96] This argument may particularly be justifiable in the situation where the whole claim is fabricated, but not so convincing in the situation where a legitimate claim is inflated or supported by fraudulent devices. The Law Commissions might have intended to differentiate two types of fraud in the context of claiming damages. In the case of wholly invented fraudulent claim, the Law Commissions' opinion is that the remedy of forfeiture has little practical effect; therefore damages shall be introduced to perform the function of compensation and deterrent. However, in the case of the legitimate claims containing fraudulent element or legitimate claims subsequent to fraudulent claim, the logic of the Law Commissions seems to be that insurer could have been responsible for the legitimate claim if there was no fraud. Accordingly, by enforcing the remedy of forfeiture of the whole claim even the subsequent claims, insurer has saved the money that would have been paid, so this part of money shall be regarded as the insurer's gain and shall be used to offset the investigation cost for the purpose of revealing the true loss of the insurer. The logic is legally comprehensible, but it may not be easy to practice because the burden rests upon the shoulder of insurer to differentiate the actual loss from the ordinary cost of handling the claim, as Association of British Insurers worries that it may be an "unnecessary complication."[97] The second concern is also from the practical perspective. The General Council of the Bar comments that it would be difficult for the insurers to recover the damages because most fraudsters do not have substantial means or have managed to conceal such assets as they have.[98] This concern could hold true in certain situations, e.g. in the case of scuttling the vessel and the fraudsters happen to be a single-vessel company, or in the case that fraudsters have been wound up, but the difficulty in implementation should not be the reason denying the existence of the

[95] Consultation Paper 7.32

[96] Consultation Paper 7.30

[97] Consultation Paper 7.36

[98] Consultation Paper 7.32

right to claim damages. It is believed that the existence of the right itself in law will be a deterrent message if it made known to the public. The third concern is that the costs could get out of hand transforming a fraudulent claim for a small sum into a very large costs claim.[99] This is a genuine concern which makes the Law Commissions propose that costs spent shall be reasonable and proportionate. From the perspective of economics, the insurer is in a better position to avoid unnecessary costs in the investigation costs, so the rule should creates sufficient incentives to avoid the waste. If it is predictable that the costs would be significant, then insurers may have incentives or they may be forced to include an express condition in the contract suppressing the confinement of the legislation. However, it is also noticeable from the other perspective that if a potential fraudster is made known that his fraudulent act, if found, may lead to a damage claim, then as a reasonable economic human being who usually considers the issue from a cost-benefit perspective, it is possible that he will not take the risk of being caught by just submitting a small sum of fraudulent claim.[100] The real problem might be that the amount of damages claim is under the judge's discretion depending upon the surrounding circumstances of the case in question which may bring a degree of uncertainty into this area of law.

[6.18] In conclusion, it is submitted that statutorily amending the judgement made in *London Assurance v Clare* and confirming insurer's right to claim investigation costs as damages should be welcomed. This proposal is generally in conformity with the principles of normal contract law in the sense that damage shall be available in the case of breach of contract but shall be awarded for the sole purpose of compensation. This proposed sub-section may become the most controversial part in the court, provided it is approved by the Parliament in the first place, in the sense that both the existence and the amount of damages may not be easy to establish. Nevertheless, it shall be borne in mind that difficulty in assessing damages does not disentitled an

[99] Consultation Paper 7.33

[100] From perspective of economics, this arrangement could operate as preventive measure and provide incentives to the insured to acting honestly. See Chapter Five, at [5.46]-[5.47]

insurer from having an attempt made to assess them;[101] and it is insurer's burden to prove the reasonable and proportionate costs have been incurred, failing to do so will debar him from recovering.[102] Although the Law Commissions have anticipated that this remedy will not be invoked often, the proposal should be supported in principle and the true effect of it should be left to the court for further test.

E. Miscellaneous: fraud in co-insurance and group insurance

[6.19] The Law Commissions have also devoted a whole part of Consultation Paper to consider the issues when a fraudulent claim is submitted by a co-insured, or by a member of a group scheme. These two issues have no significance in the context of business insurance and will, therefore, not be discussed for the purpose of this thesis.[103]

---

[101] Beatson, J & Burrows, A & Cartwright, J, *Anson's Law of Contract*, 29th edn, Oxford (2010), 535

[102] It is inevitable that this statute will cost the insurer some money for the purpose of training the employees, e.g. to differentiate the actual loss of investigation cost and normal cost of running claim process , but it can be regarded as the one-off costs of familiarisation and can be absorbed into the firms' normal training activities. See the Law Commissions' Impact Assessment: *Updating Insurance Contract Law: post-contract duties and other issues, Evidence Base*, 1.98

[103] With regard to co-insurance issue, only one relevant case in this respect could be found in the Financial Ombudsman Service records so far. It should be noted that the main function of FOS is to settle the disputes between consumers and their financial service providers. See Consultation Paper 9.19. Group insurance scheme issue primarily relates to life insurance and other long-term benefits and therefore is not an important issue in commercial insurance. See Consultation Paper 9.23. Nevertheless, in co-insurance cases, the Law Commissions propose that no legislation is needed in this area but they suggest that if an innocent joint insurer could prove a wrongful act is carried out without his knowledge, he may not be responsible for it. In Group insurance situations, the Law Commissions propose that insurer should be entitled to exercise the same remedies against the group member as he would have against a policy; but fraud committed by one group member would not affect other members' benefit.

IV. Conclusions

[6.20] A French politician and professor of law Georges Ripert once wrote that: "the notion of law is a static one. I do not mean thereby that laws have not changed and will not or ought not to change. But I wish to affirm that it is in their nature to endure and not in their nature to change."[104] This observation demonstrates that in nature the law is conservative and stable. However, being an integral part of the society, the law also has to keep pace with social change. The current insurance contract law is largely stipulated in a codified legislation based upon Nineteen Century cases and values, and it is with no doubt that some of them are out of date. Those dated rules may have already endangered London's position as the world centre of commercial insurance; therefore they should be modernized properly and carefully. One of the effective ways of modernization of the law is through reform. The reform, as opposed to revolution, shall imply a degree of conservation and preservation in the sense that its purpose is to save the old rules by adapting them to new circumstances.[105] It is submitted that the Law Commissions' approach to reform the remedy of fraudulent claims in insurance contract indeed follows this inherent implications. The Law Commissions do not choose a more revolutionary way of reforming Section 17 of the Marine Insurance Act 1906. Instead, they choose to restore the long-established position of common law of forfeiture and modernize the rule by clarifying its blurry effect on the subsequent claims. In addition, the contractual nature of insurance contract is stressed with the effect that a statutory condition precedent is introduced and damages are available as a remedy against insured's fraudulent act. In the Law Commissions' proposal, no radical step has been taken; the change derives from principles deeply embedded in the history of common law, so the past has been connected with the present while the future has not been overlooked.

---

[104] Georges Ripert, *Les forces creatrices du droit*, (Paris 1995), 19, translated by Professor Jean Beetz. See Beetz ,J, *Reflection on continuity and change in law reform*, 22 University of Toronto Law Journal 129 (1972), 132

[105] Beetz, J, *Reflection on continuity and change in law reform*, 22 University of Toronto Law Journal 129 (1972), 138-139

[6.21] Lord Justice Aikens once warned that reform shall not be done for the sake of tidiness,[106] but the Law Commissions' proposal has done more than that: it clarifies the irreconcilable confusion under the current legal regime and tries to make the law fairer. The Law Commissions' previous proposal on the duty of disclosure and warranties in business insurance has received some doubt and criticism owing to its radicalness;[107] clearly they have learned some lessons and accordingly, a mild reform essentially cling to current legal practice and existing legal principle has been presented. Despite some suggestions may result in further judicial controversies, e.g. the assessment of damages, which is inevitable, it is pleasing to see that the essence of the proposal of the Law Commissions is in line with the main conclusions reached in Chapter Four and Five of this thesis. Hopefully, with the upcoming proposal on duty of disclosure and warranties in business insurance context, the Law Commissions' project would bring the law of business insurance contract into a new era, which will continue to well-serve the United Kingdom and the international business community in the long run.[108]

---

[106] Aikens, *The post-contract duty of good faith in insurance contracts: is there a problem that needs a solution?* [2010] JBL 379, 393

[107] See Soyer, B, *Reforming pre-contractual information duties in business insurance contracts-one reform too many?* [2009] JBL 15. See also generally, Soyer, B (Ed), *Reforming Marine and Commercial Insurance law*, Informa (2008)

[108] Aikens, *The post-contract duty of good faith in insurance contracts: is there a problem that needs a solution?* [2010] JBL 379, 393

CONCLUSIONS

For every good reason there is a lie, there is a better reason to tell the truth.

——Bo Bennett

It is true that certainty is paramount in commercial law, and the certainty is indeed a "traditional strength and major selling point of English commercial law."[1] However, the pursuit of certainty does not necessarily mean that the law should stand still and refrain from changing or developing. This proposition is particularly true with regard to the current status of English commercial insurance contract law.

The Marine Insurance Act 1906 successfully codified the fundamental principles of marine insurance law, being applicable to non-marine insurance too, established by Lord Mansfield and other great common law lawyers in 18th and 19th centuries, but the story does not end at the year of 1906. A new body of insurance law has been created by the learned judges by adopting the process of interpreting the Act and applying it to the new situations. The Act just cannot plainly be isolated from those judicial decisions that construe it.[2] Thus, the old Act is developed and is given a fresh blood in the new era. However, it should be remembered that the judicial interpretation of the Act must be controlled by the wording of the Act and accordingly, the learned judges are not allowed to deviate substantially from the wording of the Act without just cause and develop the law in an unlimited fashion. The most unpleasant example in this regard, which has already caused several confusions, is the remedy encapsulated in the Section 17 of the Act, which stipulates that avoidance *ab initio* is the only remedy available for the breach of duty of utmost good faith and this remedy has been considered as being harsh and draconian.

---

[1] *The Golden Victory* [2007] UKHL 12, [2007] 2 WLR 691, [1] (Lord Bingham)

[2] Burrows, A, *The relationship between common law and statute in the law of obligations* (2012) 128 LQR 232, 240

The Act and its judicial interpretations are not the only two sources of commercial insurance law. Contributions also come from the practice of insurance market. In order to address the problems caused by the Act and the judicial interpretations attributed to it, a wide range of contractual clauses are designed and introduced to the standard insurance contract, as illustrated by Professor Soyer that: "it is not an exaggeration to suggest that the contemporary insurance practice has left the Act behind in certain respects".[3] However, this can be remedied if the Act is amended through legislative reform and in this way a message could be sent to "the rest of the world that the London market is determined to operate under new legal rules designed to protect the interests of both parties."[4]

The issues of fraudulent insurance claims are amongst those areas that need to be reformed. The main purpose of the reform should be to clarify the current judicial perplexities and set out the clear penalties in law, so a clear message could be sent to the potential fraudsters. Only in this way the law could perform its deterrent function.

Proposals

All in all, the conclusions reached by the author broadly accord with the Law Commissions' proposal and they could be summarized as follows:

1. A strict definition of fraudulent insurance claims is not necessary for two reasons: (1) the concept of fraud must adapt to the rapidly changing social circumstances; and (2) the determination of the fraudulent behaviour of the insured depends to a great extent upon the facts of individual cases. However, it does not necessarily mean that the basic form and structure of insurance fraud must change as well. At least, two basic elements must be satisfied for the purpose of establishing the fraud: (1) objectively, it must be proved that the statements made by the insured with regard to the claim or the factual matrix of the claim are false; and (2) subjectively, it must also be proved that the insured knows the falsity of the

[3] Soyer, B, (Ed), *Reforming Marine and Commercial Insurance Law*, Informa (2008), vii

[4] *Ibid.*, viii

statements but still has the intention to defraud the insurer for the purpose of financial gain.

2. The burden of proof is firmly on the shoulder of the insurer to prove that the insured has engaged in fraudulent activities. Strong evidence is generally required, and the more serious the allegations are, the higher degree of proof is required. The insurer will not be given the benefit of doubt in ambiguous cases. However, if the fraud is established, the courts will generally not hesitate to deliver the judgements against those involved in fraud even if the fraud is not directly linked with the claim.

3. The author and the Law Commissions both propose that, without the unambiguous and crystal clear wording in the insurance contract, avoidance *ab initio* should not become a default legislative remedy against insurance fraudulent claims. More precisely, the remedy of avoidance *ab initio* encapsulated in Section 17 of the Marine Insurance Act 1906, by operation of law, if applied post-contractually, will invalidate the previous legitimate claim paid under the policy and radically disturb the certainty of legal relationship between insurer and insured. It is an inefficient remedy and is particularly unjust and inappropriate in the situation in which a single false claim is submitted very late in the period of a long-running policy.

4. The author and the Law Commissions both submit that the most appropriate method to tackle the insurance fraudulent claims is to insert a fraudulent claims clause into the insurance contract. In order to function appropriately, the clause must be drafted in a proper and careful fashion. Most significantly, it must state clearly and unambiguously the consequences of fraud. If the wording of the clause makes the legal position clear, the courts should not invalidate the application of the clause even if the consequence stipulated is avoidance *ab initio*. The acknowledgement of this legal position demonstrates that the application of fraudulent claims clause is ultimately a question of interpretation and as the starting point, the natural meaning of the words, if made clear, should be followed even if it seems harsh or unreasonable. After all, it should be borne in mind that

in commercial contracts, parties are assumed to be capable of taking care of their own interest. If the insured agrees to use avoidance *ab initio* as the remedy provided by the terms of contract, this provision would be regarded as an outcome of freedom of contract and, therefore, legally justifiable and economically efficient.

5. In the absence of the express fraudulent claims clause, the author and the Law Commissions both submit that the common law rule of forfeiture should prevail. That is to say, the insured who commits a fraud in relation to a claim forfeits the whole claim to which the fraud relates, even the honest part of the claim. Any interim payments made in respect of the claim must be repaid. Furthermore, the Law Commissions propose that the insurer also forfeits any claim which arises after the date of the fraud. In other words, refraining from fraud on the part of the insured should be treated as a condition precedent as to the insurer's liability in respect of the subsequent losses and claims. That is to say, the fraud not only has effects on the tainted claim but also could essentially allow the insurer to be discharged from the contract. The author concludes that this approach is in line with the general principle of contract law and should be supported. If it proves difficult to implement the reform advocated by the Law Commissions, the author proposes that courts should consider implying a contractual term in appropriate cases.

6. The author and the Law Commissions both propose that insurer should be entitled to claim damages, namely investigation costs, as a result of insured's fraudulent activities. This proposal is theoretically justifiable as it accords with the normal contractual approach of awarding damages. The Law Commissions further submit that, for which the author agrees, pursuant to the compensatory principle governing the rules of awarding damages, insurer should be entitled to claim the investigation costs actually, reasonably and proportionately incurred in investigating the fraud. However, if the insurer has saved the money that would have been paid by invoking the forfeiture remedy, e.g. in cases where a legitimate claim is supported by fraudulent means and devices, this amount of money should

be used to offset the investigation costs for the purpose of reflecting the true loss position of the insurer.

7. It is argued in this thesis that reform proposals made by the author and the Law Commission are in accordance with the general principles of contract law and established practices. The old rules are not fit to provide solutions in the 21st century; the certainty of law would not be disturbed in the name of reform and the cost of reform would not be high. Accordingly, the reform proposal is legally justifiable and economically efficient

The Future of Section 17 of the Marine Insurance Act 1906

Following the proposals that contractual and common law principles instead of Section 17 of the Marine Insurance Act 1906 should govern the jurisdiction of fraudulent insurance claims, a further amendment may also need to be made on Section 17 itself in order to conquer the conceptual difficulty that the presentation of fraudulent claims, being a very clear-cut type of bad faith, is surprisingly not covered by the duty to exercise good faith.

Section 17 provides 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." With no doubt at all, it is the core provision of the Act. However, admittedly, the Section is not flawless. As it has been comprehensively analyzed in Chapter Four, the main problem identified is that the Section only provides one remedy, namely avoidance *ab initio*, for the breach of duty of utmost good faith. This problem not only makes the post-contractual application of Section 17 unfair and unprincipled, but also causes difficulties in several other contexts, e.g. breach of insurer's duty of utmost good faith.

The reform on Section 17 in due course may become necessary and inevitable, but "how to reform" could still cause considerable controversy and debate. The author of the thesis tentatively and briefly proposes that the time may be ripe to jump out of the

constraint of Common Law system and resort to the measures taken by Continent Law system.

In Principles of European Contract Law, the duty of good faith is stipulated as a basic principle running through the Principles. Article 1:201 says that "each party must act in accordance with good faith and fair dealings". It is clear from the wording of the Article that the Article is not confined to any specific situations and should be followed in the formation, performance and enforcement of the parties' duty throughout the contract. Particular applications of the Article are stipulated in the following Articles of the Principles.[5] It is evidently noticeable that the Article does not provide any remedy for the breach of the duty of good faith and therefore, its function is not to establish any cause of action but to provide a general interpretative guidance for the applications of other relevant Articles in the Principles.

Similarly, in the United Nations Convention on International Sale of Goods (Vienna Convention), the notion of good faith is categorized as a general interpretative principle as well. Article 7 states that: "in the interpretation of this Convention, regard is to be had to the observance of good faith in international trade."

The legislative modes of the duty of good faith in Principles of European Contract Law and Vienna Convention have implications for the reform of Section 17 of the Marine Insurance Act 1906. A brief and tentative proposal, therefore, made by the author of this thesis is that the remedy statement provided by Section 17 should be removed. Instead, the specific remedy should be written into the relevant Sections of the Act where it is necessary and appropriate, e.g. pre-contractually, non-disclosure and misrepresentation, and post-contractually, the submission of fraudulent claims. The function of Section 17 will be interpretative: the duty of good faith still needs to be observed throughout the various stages of the insurance contract by both insurer and insured and Section 17 will be relevant to interpret the obligations of the parties in the appropriate situations.

---

[5] Lando, O& Beale, H (Ed), *Principles of European Contract Law: Parts I and II*, Kluwer Law International (2000), 113

Last but not least, it should be brought into attention that in a South Africa case *Mutual and Federal Insurance Company Ltd* v. *Municipality of Oudtshoorn*,[6] the notion of "utmost good faith" was rejected. The Court stated that: "There are no degrees of good faith. It is entirely inconceivable that there could be a little, more or most (utmost) good faith. The distinction is between good faith or bad faith. There is no room for *uberrima fides* as a third category of faith in our law." The opinion of the Court was endorsed by Professor Howard Bennett in his influential article *Mapping the doctrine of utmost good faith in insurance contract*,[7] where he also recognized that "utmost good faith" was not a Lord Mansfield's original formulation but a 19th century addition. Therefore, when Section 17 is amended, it may need to consider that it should be referred to as "good faith" rather than "utmost good faith".

The Role of Criminal Penalties

The author honestly believes that all fraud is wrong and should be avoided at any cost. A person could make the money fast by other ways. The author also believes that fighting against the insurance fraud is not the business of the insurer only. The whole society should take part in penalising the insurance fraudsters. The thesis extensively explored the civil aspects of the English position in respect of the problem of fraudulent claims in commercial insurance, but it should also be clearly recognized that civil law remains but one aspect, albeit a highly important one, of addressing the issues. The role of criminal penalties is also needed to be briefly considered.

The message sent by criminal law is crystal clear: "insurance fraudsters risk reflecting on their crime from a prison cell."[8] It is very fortunate that insurance fraud is indeed a criminal offence in the UK jurisdiction. Insurance claims that are entirely fraudulent and those that are exaggerated through either claiming for injury, loss or damage that did not occur or increasing the value of a genuine claim for injury, loss or damage are

---

[6] [1985] 1 All SA 324 (A), [33]

[7] [1999] LMCLQ 165

[8] "*Prison warning to insurance cheats*", ABI News Release, 22nd October 2002, http://www.abi.org.uk/Media/Releases/2002/10/Prison_warning_to_insurance_cheats.aspx, accessed on 24 July 2012

regarded as offence under the Fraud Act 2006[9] and are punishable by up to 10 years in prison.[10]

In order to successfully prosecute the offence, the information on fraudsters must be properly gathered and the evidence must be properly prepared. In this regard, it is pleasing to see that on the 3rd January 2012, UK's first dedicated insurance specialist police unit has launched for the purpose of tackling and combating the criminal threat of insurance fraud. This Insurance Fraud Enforcement Department (IFED) is run by the City of London Policy and supported by the Association of British Insurers (ABI), and it will act on evidence of motor insurance, commercial insurance, public liability fraud and illegal insurance advisers. City of London Policy Commander Ian Dyson commented that IFED "is here to turn the tide against all those who break the law, dismantling far-reaching criminal networks and changing a culture that says it is ok to submit bogus insurance claims. There is much to be done and there is not a moment to lose." The ABI's Director of General Insurance Nick Starling also said that: "The message could not be clearer: now more than ever anyone making a dishonest insurance claim is not only likely to get caught, but risks getting a criminal record and

---

[9] According to Sections 1 and 2 of the Act, a person is guilty of fraud if he dishonestly makes a false representation, and intends, by making the representation, to make a gain for himself or another, or to cause loss to another or to expose another to a risk of loss. According to subsections (2) to (5) of Section 2, there is basically no difference between civil law and criminal law for the purpose of determining the meaning of "false representation". The Crown Prosecution Service recognized that "the borderline between criminal and civil liability is likely to be an issue in alleged Fraud Act offences particularly those under Section 1" and further suggested that: "prosecutors should guard against the criminal law being used as a debt collection agency or to protect the commercial interests of companies and organizations. However, prosecutors should also remain alert to the fact that such organizations can become the focus of serious and organized criminal offending." See Legal Guidance provided by the Crown Prosecution Service on its website at http://www.cps.gov.uk/legal/d_to_g/fraud_act/#charging, accessed on 22nd July 2012

[10] See Sentencing Guidelines Council, *Sentencing for Fraud-Statutory Offences Definitive Guideline*, http://sentencingcouncil.judiciary.gov.uk/docs/web_sentencing_for_fraud_statutory_offences.pdf, accessed on 22nd July 2012

certainly more expensive and harder to obtain insurance and other financial products in the future."[11]

The Finale

In 1953, when Lord Denning delivered a lecture about the influence of religion on law, he identified "truth" as one of the fundamental principles of our law and he linked this concept to the Christian religion. He made the following observations on the topic, which the author would like to use, with great honor, to end the whole thesis: [12]

> "Just as the psalmist commends the man who 'speaketh the truth from his heart,' so also St. Paul enjoins the early Christians in these words: "Wherefore putting away lying, speak every man truth with his neighbor: for we are members one of another.' If there is one thing that gives rise to more resentment than anything else it is to be deceived - to be told a lie. It is an affront to the whole personality. Just as we do not wish others to deceive us, so we should not deceive them."

---

[11] "*UK's first insurance fraud unit launches today*", City of London Policy, http://www.cityoflondon.police.uk/CityPolice/Media/News/IFEDlaunchestoday3012012.htm, accessed on 22 July 2012

[12] Denning, *The Changing Law*, Stevens & Sons (1953), 100-101

BIBLIOGRAPHY

BOOKS

Andrews, N & Clarke, M &Tettenborn, A &Virgo, G, *Contractual Duties: Performance, Breach, Termination and Remedy*, Sweet&Maxwell (2012)

Atiyah, *An Introduction to the Law of Contract*, 5th edn, Oxford (1995)

Austen-Baker, R, *Implied terms in English Contract Law*, Edward Elgar (2011)

Baird &Gertner &Picker, *Game Theory and Law*, Harvard University Press (1994)

Barlow Lyde & Gilbert LLP (Ed), *Reinsurance Practice and The Law*, Informa (2008)

Beale, H, (Ed), *Chitty on Contracts*, 30th edn, Sweet&Maxwell (2008)

Beatson, J & Burrows, A & Cartwright, J, *Anson's Law of Contract*, 29th edn, Oxford (2010)

Bennett, C, *Dictionary of Insurance*, 2nd edn, Prentice Hall (2004)

Bennett, H, *Law of Marine Insurance,* 2nd edn, Oxford (2006)

Bingham, T, *The Rule of Law*, Allen Lane (2010)

Borch, *Economics of Insurance*, North-Holland (1990)

Brownsword, R, *Contract Law: themes for the twenty-first century*, 2nd edn, Oxford (2006)

Cardozo, *The Growth of the Law*, New Haven (1924)

Cartwright, J, Misrepresentation, *Mistake and Non-disclosure*, 2nd edn, Sweet&Maxwell (2012)

Chalmers & Owen, *The Marine Insurance Act 1906*, London (1907)

Chapman,M, *Fraudulent Claims: deceit, insurance and practice,* Tarquin Publications (2007)

Clarke, M, *Policies and Perceptions of Insurance Law in the Twenty-First Century,* Oxford (2005)

Clarke, M, *The Law of Insurance Contract*, 6th edn, Informa (2009)

Cooter, R & Ulen, T, Law *& Economics*, 5th edn, Pearson (2008)

Cornish& Nolan& O'Sullivan& Virgo (Ed), *Restitution-Past, Present and Future-Essays in Honour of Gareth Jones,* Hart Publishing (2000)

Denning, *The Changing Law*, Stevens & Sons (1953)

Dennis, I, *The Law of Evidence*, 3rd edn, Sweet&Maxwell (2007)

Dunt, J, *Marine Cargo Insurance*, Informa (2009)

Edelman, *Gain-based Damages: Contract, Tort, Equity and Intellectual Property*, Hart Publishing (2002)

Eggers, PM & Picken, S& Foss, P, *Good Faith and Insurance Contracts*, 3rd edn, Lloyd' list (2010)

Eggers, PM, *Deceit: The Lie of Law*, Informa (2009)

Forte, A, (Ed), *Good Faith in Contract and Property Law*, Hart Publishing (1999)

Friedman, D, *Law's Order: What Economics Has to Do With Law and Why It Matters*, Princeton University Press (2000)

Geest (Ed), *Contract Law and Economics*, Edward Elgar (2011)

Gilman, J(Ed), *Arnould's Law of Marine Insurance and Average*, 17th edn, Sweet&Maxwell (2008)

Greenberg, D, *Stroud's Judicial Dictionary of Words and Phrases*, 7th edn, Sweet&Maxwell (2008)

Halsbury's Law of England, 4th edn (1992)

Handley, *Spencer Bower, Turner and Handley on Actionable Misrepresentation*, 4th edn, Butterworths (2000)

Henley, C, *Drafting Insurance Contracts, Leadenhall Press* (2010)

Hill, J (Ed), *O'May on Marine Insurance Law and Policy*, Sweet&Maxwell (1993)

Hodges, S, *Cases and Materials on Marine Insurance Law,* Cavendish Publishing (1999)

Huybrechtes, M(Ed), Hooydonk, EV & Dieryck, C (Co-eds), *Marine Insurance at the turn of the Millennium, Volume 1*, Intersentia (1999)

Ivamy, ERH, *Marine Insurace,* 4th edn, Butterworth (1985)

Jones, MA& Dugdale,A (Ed), *Clerk&Lindsell on Torts*, 20th edn, Sweet&Maxwell (2010)

Lando, O& Beale, H (Ed), *Principles of European Contract Law: Parts I and II*, Kluwer Law International (2000)

Legh-Jones, N (Ed), *MacGillivray on Insurance Law*, 11th edn, Sweet&Maxwell (2008)

Lewison, K, *The Interpretation of Contracts,* 5th edn, Sweet&Maxwell (2011)

Longman Dictionary of Contemporary English, Pearson Education Limited (2001)

Lowry, J & Rawlings, P & Merkin, R, *Insurance Law: Doctrines and Principles,* 3rd edn, Hart Publishing (2011)

Mance & Goldrein, I & Merkin, R (Ed), *Insurance Disputes*, 3rd edn, Informa (2011)

Marks & Balla, *Guidebook to Insurance Law in Australia*, 2nd edn, Norty Ryde(1987)

McGrath, P, *Commercial Fraud in Civil Practice*, Oxford (2008)

McKendrick, E, *Contract Law: Text, Cases and Materials*, 3rd edn, Oxford (2008)

McMeel, G, *The Construction of Contracts: Interpretation, Implication and Rectification*, Oxford (2007)

Mercuro, N& Medema, SG, *Economics and Law: From Posner to Post-modernism*, Princeton University Press (1997)

Merkin, R & Flannery, L, *Arbitration Act 1996*, 4th edn, LLP (2008)

Merkin, R, *Colinvaus's Law of Insurance*, 8th edn, Sweet&Maxwell (2006)

Merkin, R, *Colinvaux & Merkin's Insurance Contract Law* (loose-leaf), Sweet&Maxwell (2007)

Merkin, R, *Marine Insurance Legislation,* 4th edn, Informa (2010)

Mitchell, C& Mitchell, P (Ed), *Landmark Cases in the Law of Contract*, Hart Publishing (2008)

Morse, D & Skajaa, L, Tackling Insurance Fraud: Law and Practice, LLP (2004)

Mowbary, AH, *Insurance*, 3rd edn, McGraw-Hill Book Company (1946)

Mullany, NJ & Linden, AM (Ed), *Torts Tomorrow: A Tribute to John Fleming,* North Ryde (1998)

O'Sullivan, D& Ellliott,S& Zakrzewski, R, *The Law of Rescission*, Oxford (2008)

Padfield, A, *Insurance Claims*, 2nd edn, Tottel Publishing (2007)

Peel, E, *Treitel, The Law of Contract,* 13th edn, Sweet & Maxwell (2011)

Posner, *Economic Analysis of Law*, 7th edn, Wolters Kluwer (2007)

Pratt & Zeckhauser (Ed), *Principals and Agents: the structure of business,* Harvard Business School Press (1991)

Reynolds, FB (Ed), *Bowstead&Reynolds on Agency*, 19th edn, Sweet&Maxwell (2010)

Robbins, *An Essay on the Nature and Significance of Economic Science*, London Macmillan (1907)

Rose, FD, *Marine Insurance: Law and Practice,* Informa (2004)

Soyer, B, (Ed), *Reforming Marine Insurance and Commercial Insurance Law,* Informa (2008)

Soyer, B, *Warranties in Marine Insurance*, 2nd edn, Cavendish Publishing (2005)

Spry, *The Principles of Equitable Remedies,* 4th edn, Sweet&Maxwell (1990)

Summer, PJ, *Insurance Law and The Financial Ombudsman Service*, Lloyd's List (2011)

Tettenborn, A, (Ed), *The Law of Damages*, LexisNexis (2003)

Thomas, DR (Ed), *Marine Insurance: Law in Transition,* Informa (2006)

Thomas, DR (Ed), *The Modern Law of Marine Insurance Vol.1,* LLP (1996)

Thomas, DR (Ed), *The Modern Law of Marine Insurance Vol.2,* LLP (2002)

Thomas, DR (Ed), *The Modern Law of Marine Insurance Vol.3,* LLP (2009)

Thoyts, R, *Insurance Theory and Practice*, Routledge (2011)

Trebilcock, MJ, *The limits of Freedom of Contract*, Harvard University Press (1997)

Ulph, J, *Commercial Fraud,* Oxford (2006)

Veljanovski, *Economic Principles of Law*, Cambridge University Press (2007)

Wilken, S & Ghaly, K, *The Law of Waiver, Variation, and Estoppel*, 3rd edn, Oxford (2012)

Willett, AH, *The Economic Theory of Risk and Insurance*, University Press of the Pacific Honolulu (1901)

Worthington, S, (Ed.), *Commercial Law and Commercial Practice*, Hart Publishing (2003)

Zewifel, P& Eisen, R, *Insurance Economics*, Springer (2012)

Zweigert, K & Kotz, H, *Introduction to Comparative Law*, 3rd edn, Oxford (1998)

ARTICLES

Adams & Brownsword, *The Ideologies of Contract Law* (1987) 7 Legal Studies 205

Arrow, *Uncertainty and the Welfare Economics of Medical Care,* American Economic Review (American Economic Association) Vol.53, No.5 (Dec 1963)

Austen-Baker, R, *Comprehensive Contract Theory: a Four-Norm Model of Contract Relations* (2009) 25 Journal of Contract Law 216

Bennett, H, *Mapping the doctrine of utmost good faith in insurance contract*, [1999] Lloyd's Maritime and Commercial Law Quarterly 165

Beetz ,J, *Reflection on continuity and change in law reform*, 22 University of Toronto Law Journal 129 (1972)

Burrows, A, *The relationship between common law and statute in the law of obligations* (2012) 128 Law Quarterly Review 232

Carter & Peden, *Good faith in Australian Contract Law* (2003) 19 Journal of Contract Law 155

Chalmers, *Codification of Mercantile Law* (1903) 19 Law Quarterly Review 10

Coase, *The Problem of Social Cost*, 3 Journal of Law & Economics 1 (1960)

Cohen, *Implied terms and Interpretation in Contract Law*, Virginia Law and Economics Research Paper No. 2009-12

Coleman, *Efficiency, Exchange and Auction: Philosophical Aspects of the Economic Approach to Law,* 68 California Law Review, 221-249

Davey, J, *Unpicking the Fraudulent Claims Jurisdiction in Insurance Contract Law: Sympathy for the Devil?* [2006] Lloyd's Maritime and Commercial Law Quarterly 223

Dionne & Gagné, *Deductible Contracts against Fraudulent Claims: Evidence from Automobile Insurance*, Review of Economics and Statistics 83: 290-301

Eggers, PM, *Remedies for the Failure to Observe the Utmost Good Faith* [2003] Lloyd's Maritime and Commercial Law Quarterly 249

Farber, *Contract law and Modern Economic Theory*, 78 Northwest University Law Review (1983), 303

Friedmann, *The Performance Interest in Contract Damages* (1995) 111 Law Quarterly Review

Goetz & Scott, *The Limits of Expanded Choice: An Analysis of the Interactions between Express and Implied Contract Terms*, 73 California Law Review, 261-322

Hart &Moore, *Incomplete Contracts and Renegotiation*, 56 *Econometrica*, 755-785

Kirby, M, AC CMG, *Australian Insurance Contracts Law: Local Reform with a Global Relevance*, [2011] Journal of Business Law 309

Longmore, *An Insurance Contracts Act for a new century* [2001] Lloyd's Maritime and Commercial Law Quarterly 356

Longmore, *Good faith and breach of warranty: are we moving forwards or backwards* [2004] Lloyd's Maritime and Commercial Law Quarterly 158

Mance, *The 1906 Act, common law and contract clauses-all in harmony?* [2011] Lloyd's Maritime and Commercial Law Quarterly 346

Miyazaki, *Perceived Ethicality of Insurance Claim Fraud: Do Higher Deductibles Lead to Lower Ethical Standards*, Journal of Business Ethics (2009) 87: 589-598

Mustill, *Fault and Marine Losses*, [1988] Lloyd's Maritime and Commercial Law Quarterly 310

Peden, *Policy concerns in terms implied in law* (2001) 117 Law Quarterly Review

Rappaport, *Abstraction and Unrealistic Assumptions in Economics*, Journal of Economic Methodology, 1996, 3(2), 215–236

Scott, *Damages* [2007] Lloyd's Maritime and Commercial Law Quarterly 465

Shine, P, *Dishonesty in civil commercial claims: a state of mind or a course of conduct* [2012] Journal of Business Law 29

Skajaa, L, *Fraudulent devices-the market response (International Hull Clauses 2003)* [2004] Lloyd's Maritime and Commercial Law Quarterly 139

Skajaa, L, *International Hull Clauses 2002: a contractual solution to the uncertainty of the fraudulent claims rule?* [2003] Lloyd's Maritime and Commercial Law Quarterly 279

Soyer, B, *Continuing Duty of Utmost Good Faith: Still Alive?* [2003] Lloyd's Maritime and Commercial Law Quarterly 39

Soyer, B, *Defence Available to a Marine Insurer* [2002] Lloyd's Maritime and Commercial Law Quarterly 199

Soyer, B, *Reforming pre-contractual information duties in business insurance contracts-one reform too many?* [2009] Journal of Business Law 15 ✓

Soyer, B, *The Star Sea-a lode star?* [2001] Lloyd's Maritime and Commercial Law Quarterly 428

Tarr, *Fraudulent Insurance Claims: Recent legal Developments* [2008] Journal of Business Law 139 ✓

Tennyson, *Insurance Experience and consumer's attitudes toward insurance fraud,* Journal of Insurance Regulation 21 (2), 35-55

Thomas, DR, *Fraudulent Insurance Claims: definition, consequences and limitations* [2006] Lloyd's Maritime and Commercial Law Quarterly 485

Trebilock, MJ, *The Doctrine of of Inequality of Bargaining Power: Post-Benthamite Economics in the House of Lords,* 26 University of Toronto Law Journal 359 (1976)

Zheng, R, *Moral Hazard and The Use of Fraudulent Means and Devices in Making a Legitimate Insurance Claim* [2011] Journal of International Maritime Law 260

PAPERS

Brownsword, R, An Introduction to Legal Research, available at http://www.wellcome.ac.uk/stellent/groups/corporatesite/@msh_grants/documents/web_document/wtx030897.pdf [accessed on 5th April 2012]

Clift, R, *Fraud: Does the punishment fit the crime?* Speech at International Marine Claim Conference (IMCC), Dublin, 2007, available at http://www.marineclaimsconference.com/2007/index.html [accessed on 4th April 2012]

Clift, R, *Fraudulent Insurance Claims,* available at http://www.hilldickinson.com [accessed on 6th April 2012]

Herbert Smith, *Insurance and reinsurance litigation Bulletin,* 1 April 2010, available at www.hebertsmith.com [accessed on 6th April 2012]

Kennedys and Crawford, *Fraud Investigation, A Claim Handler's Guide,* available at http://www.cila.co.uk/files/Anti-Fraud/Fraud_Guide.pdf [accessed on 3rd April 2012]

Lammers, F & Schiller, J, *Contract Design and Insurance Fraud: an Experimental Investigation,* FZID Discussion Paper No. 19/2010, available at https://fzid.uni-hohenheim.de/71978.html[accessed on 6th April 2012]

Mance, *Should the Law be certain?* The Oxford Shrieval lecture, 11th October 2011, available at http://www.supremecourt.gov.uk/docs/speech_111011.pdf [accessed on 4th April 2012]

Merkin, R, *Fraudulent Claims*, paper delivered at the New Zealand Insurance Law Association conference, 2000, available at http://www.nzila.org/index.asp [accessed on 3rd April 2012]

Scott, R, *Insurance Fraud Indicators*, available at http://www.crimetime.com [accessed on 3rd April 2012]

OFFICIAL REPORTS

Law Commission: *Insurance Law: Non-disclosure and Breach of Warranty*, Law Com No.104 (1980)

Law Commissions:[1] Joint Insurance Law Contract Review 2006-2013, ***Scoping Paper*** (2006)

Law Commissions: Joint Insurance Law Contract Review 2006-2013, Issues Paper 6: ***Damages for Late Payment*** (March 2010)

Law Commissions: Joint Insurance Law Contract Review 2006-2013, Issues Paper 7: ***The Insured's Post-contract Duty of Good Faith*** (July 2010)

Law Commissions: Joint Insurance Law Contract Review 2006-2013, Consultation Paper 1: ***Misrepresentation, Non-disclosure and Breach of Warranty by the Insured*** **(July 2007)**

Law Commissions: Joint Insurance Law Contract Review 2006-2013, **Consultation Paper 2:** ***Post Contract Duties and other Issues*** **(Dec 2011)**

Australia Law Reform Commission: ***Insurance Contracts*****, Report No.20 (1982)**

WEBSITES

I-LAW: www.i-law.com

WESTLAW: www.westlaw.com

HEINONLINE: http://home.heinonline.org/

ASSOCIATION OF BRITISH INSURAER*:* www.abi.org.uk

THE LAW COMMISSION: http://lawcommission.justice.gov.uk/

[1] The English Law Commission and the Scottish Law Commission

APPENDICES

LEGISLATION

1. Marine Insurance Act 1906

OFFICIAL REPORT

2. **Law Commissions: Joint Insurance Law Contract Review 2006-2013, Consultation Paper 2:** ***Post Contract Duties and other Issues*** **(Dec 2011)**

Marine Insurance Act 1906

1906 CHAPTER 41

An Act to codify the Law relating to Marine Insurance

[21st December 1906]

Marine Insurance

1 Marine insurance defined

2 Mixed sea and land risks

3 Marine adventure and maritime perils defined

Insurable Interest

4 Avoidance of wagering or gaming contracts

5 Insurable interest defined

6 When interest must attach

7 Defeasible or contingent interest

8 Partial interest

9 Re-insurance

10 Bottomry

11 Master's and seamen's wages

12 Advance freight

13 Charges of insurance

14 Quantum of interest

15 Assignment of interest

Insurable Value

16 Measure of insurable value

Disclosure and Representations

17 Insurance is uberrimae fidei

18 Disclosure by assured

19 Disclosure by agent effecting insurance

20 Representations pending negotiation of contract

21 When contract is deemed to be concluded

The Policy

22 Contract must be embodied in policy

23 What policy must specify

24 Signature of insurer

25 Voyage and time policies

26 Designation of subject-matter

27 Valued policy

28 Unvalued policy

29 Floating policy by ship or ships

30 Construction of terms in policy

31 Premium to be arranged

Double Insurance

32 Double insurance

Warranties, etc

33 Nature of warranty

34 When breach of warranty excused

35 Express warranties

36 Warranty of neutrality

37 No implied warranty of nationality

38 Warranty of good safety

39 Warranty of seaworthiness of ship

40 No implied warranty that goods are seaworthy

41 Warranty of legality

The Voyage

42 Implied condition as to commencement of risk

43 Alteration of port of departure

44 Sailing for different destination

45 Change of voyage

46 Deviation

47 Several ports of discharge

48 Delay in voyage

49 Excuses for deviation or delay

Assignment of Policy

50 When and how policy is assignable

51 Assured who has no interest cannot assign

The Premium

52 When premium payable

53 Policy effected through broker

54 Effect of receipt on policy

Loss and Abandonment

55 Included and excluded losses

56 Partial and total loss

57 Actual total loss

58 Missing ship

59 Effect of transhipment, etc

60 Constructive total loss defined

61 Effect of constructive total loss

62 Notice of abandonment

63 Effect of abandonment

Partial Losses (including Salvage and General Average and Particular Charges)

64 Particular average loss

65 Salvage charges

66 General average loss

Measure of Indemnity

67 Extent of liability of insurer for loss

68 Total loss

69 Partial loss of ship

70 Partial loss of freight

71 Partial loss of goods, merchandise, etc

72 Apportionment of valuation

73 General average contributions and salvage charges

74 Liabilities to third parties

75 General provisions as to measure of indemnity

76 Particular average warranties

77 Successive losses

78 Suing and labouring clause

Rights of Insurer on Payment

79 Right of subrogation

80 Right of contribution

81 Effect of under insurance

Return of Premium

82 Enforcement of return

83 Return by agreement

84 Return for failure of consideration

Mutual Insurance

85 Modification of Act in case of mutual insurance

Supplemental

86 Ratification by assured

87 Implied obligations varied by agreement or usage

88 Reasonable time, etc, a question of fact

89 Slip as evidence

90 Interpretation of terms

91 Savings

92 . . .

93 . . .

94 Short title

SCHEDULES

SCHEDULE 1

SCHEDULE 2 . . .

Marine Insurance

1 Marine insurance defined

A contract of marine insurance is a contract whereby the insurer undertakes to indemnify the assured, in manner and to the extent thereby agreed, against marine losses, that is to say, the losses incident to marine adventure.

2 Mixed sea and land risks

(1) A contract of marine insurance may, by its express terms, or by usage of trade, be extended so as to protect the assured against losses on inland waters or on any land risk which may be incidental to any sea voyage.

(2) Where a ship in course of building, or the launch of a ship, or any adventure analogous to a marine adventure, is covered by a policy in the form of a marine policy, the provisions of this Act, in so far as applicable, shall apply thereto; but, except as by this section provided, nothing in this Act shall alter or affect any rule of law applicable to any contract of insurance other than a contract of marine insurance as by this Act defined.

3 Marine adventure and maritime perils defined

(1) Subject to the provisions of this Act, every lawful marine adventure may be the subject of a contract of marine insurance.

(2) In particular there is a marine adventure where--

(a) Any ship goods or other moveables are exposed to maritime perils. Such property is in this Act referred to as "insurable property";

(b) The earning or acquisition of any freight, passage money, commission, profit, or other pecuniary benefit, or the security for any advances, loan, or disbursements, is endangered by the exposure of insurable property to maritime perils;

(c) Any liability to a third party may be incurred by the owner of, or other person interested in or responsible for, insurable property, by reason of maritime perils.

"Maritime perils" means the perils consequent on, or incidental to, the navigation of the sea, that is to say, perils of the seas, fire, war perils, pirates, rovers, thieves, captures, seisures, restraints, and detainments of princes and peoples, jettisons, barratry, and any other perils, either of the like kind or which may be designated by the policy.

Insurable Interest

4 Avoidance of wagering or gaming contracts

(1) Every contract of marine insurance by way of gaming or wagering is void.

(2) A contract of marine insurance is deemed to be a gaming or wagering contract--

(a) Where the assured has not an insurable interest as defined by this Act, and the contract is entered into with no expectation of acquiring such an interest; or

(b) Where the policy is made "interest or no interest," or "without further proof of interest than the policy itself," or "without benefit of salvage to the insurer," or subject to any other like term:

Provided that, where there is no possibility of salvage, a policy may be effected without benefit of salvage to the insurer.

5 Insurable interest defined

(1) Subject to the provisions of this Act, every person has an insurable interest who is interested in a marine adventure.

(2) In particular a person is interested in a marine adventure where he stands in any legal or equitable relation to the adventure or to any insurable property at risk therein, in consequence of which he may benefit by the safety or due arrival of insurable property, or may be prejudiced by its loss, or damage thereto, or by the detention thereof, or may incur liability in respect thereof.

6 When interest must attach

(1) The assured must be interested in the subject-matter insured at the time of the loss though he need not be interested when the insurance is effected:

Provided that where the subject-matter is insured "lost or not lost," the assured may recover although he may not have acquired his interest until after the loss, unless at the time of effecting the contract of insurance the assured was aware of the loss, and the insurer was not.

(2) Where the assured has no interest at the time of the loss, he cannot acquire interest by any act or election after he is aware of the loss.

7 Defeasible or contingent interest

(1) A defeasible interest is insurable, as also is a contingent interest.

(2) In particular, where the buyer of goods has insured them, he has an insurable interest, notwithstanding that he might, at his election, have rejected the goods, or have treated them as at the seller's risk, by reason of the latter's delay in making delivery or otherwise.

8 Partial interest

A partial interest of any nature is insurable.

9 Re-insurance

(1) The insurer under a contract of marine insurance has an insurable interest in his risk, and may re-insure in respect of it.

(2) Unless the policy otherwise provides, the original assured has no right or interest in respect of such re-insurance.

10 Bottomry

The lender of money on bottomry or respondentia has an insurable interest in respect of the loan.

11 Master's and seamen's wages

The master or any member of the crew of a ship has an insurable interest in respect of his wages.

12 Advance freight

In the case of advance freight, the person advancing the freight has an insurable interest, in so far as such freight is not repayable in case of loss.

13 Charges of insurance

The assured has an insurable interest in the charges of any insurance which he may effect.

14 Quantum of interest

(1) Where the subject-matter insured is mortgaged, the mortgagor has an insurable interest in the full value thereof, and the mortgagee has an insurable interest in respect of any sum due or to become due under the mortgage.

(2) A mortgagee, consignee, or other person having an interest in the subject-matter insured may insure on behalf and for the benefit of other persons interested as well as for his own benefit.

(3) The owner of insurable property has an insurable interest in respect of the full value thereof, notwithstanding that some third person may have agreed, or be liable, to indemnify him in case of loss.

15 Assignment of interest

Where the assured assigns or otherwise parts with his interest in the subject-matter insured, he does not thereby transfer to the assignee his rights under the contract of insurance, unless there be an express or implied agreement with the assignee to that effect.

But the provisions of this section do not affect a transmission of interest by operation of law.

Insurable Value

16 Measure of insurable value

Subject to any express provision or valuation in the policy, the insurable value of the subject-matter insured must be ascertained as follows:--

(1) In insurance on ship, the insurable value is the value, at the commencement of the risk, of the ship, including her outfit, provisions and stores for the officers and crew, money advanced for seamen's wages, and other disbursements (if any) incurred to make the ship fit for the voyage or adventure contemplated by the policy, plus the charges of insurance upon the whole:

The insurable value, in the case of a steamship, includes also the machinery, boilers, and coals and engine stores if owned by the assured, and, in the case of a ship engaged in a special trade, the ordinary fittings requisite for that trade:

(2) In insurance on freight, whether paid in advance or otherwise, the insurable value is the gross amount of the freight at the risk of the assured, plus the charges of insurance:

(3) In insurance on goods or merchandise, the insurable value is the prime cost of the property insured, plus the expenses of and incidental to shipping and the charges of insurance upon the whole:

(4) In insurance on any other subject-matter, the insurable value is the amount at the risk of the assured when the policy attaches, plus the charges of insurance.

Disclosure and Representations

17 Insurance is uberrimae fidei

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.

18 Disclosure by assured

(1) Subject to the provisions of this section, the assured must disclose to the insurer, before the contract is concluded, every material circumstance which is known to the assured, and the assured is deemed to know every circumstance which, in the ordinary course of business, ought to be known by him. If the assured fails to make such disclosure, the insurer may avoid the contract.

(2) Every circumstance is material which would influence the judgment of a prudent insurer in fixing the premium, or determining whether he will take the risk.

(3) In the absence of inquiry the following circumstances need not be disclosed, namely:--

(a) Any circumstance which diminishes the risk;

(b) Any circumstance which is known or presumed to be known to the insurer. The insurer is presumed to know matters of common notoriety or knowledge, and matters which an insurer in the ordinary course of his business, as such, ought to know;

(c) Any circumstance as to which information is waived by the insurer;

(d) Any circumstance which it is superfluous to disclose by reason of any express or implied warranty.

(4) Whether any particular circumstance, which is not disclosed, be material or not is, in each case, a question of fact.

(5) The term "circumstance" includes any communication made to, or information received by, the assured.

[(6) This section does not apply in relation to a contract of marine insurance if it is a consumer insurance contract within the meaning of the Consumer Insurance (Disclosure and Representations) Act 2012.]

19 Disclosure by agent effecting insurance

[(1)] Subject to the provisions of the preceding section as to circumstances which need not be disclosed, where an insurance is effected for the assured by an agent, the agent must disclose to the insurer--

(a) Every material circumstance which is known to himself, and an agent to insure is deemed to know every circumstance which in the ordinary course of business ought to be known by, or to have been communicated to, him; and

(b) Every material circumstance which the assured is bound to disclose, unless it come to his knowledge too late to communicate it to the agent.

[(2) This section does not apply in relation to a contract of marine insurance if it is a consumer insurance contract within the meaning of the Consumer Insurance (Disclosure and Representations) Act 2012.]

20 Representations pending negotiation of contract

(1) Every material representation made by the assured or his agent to the insurer during the negotiations for the contract, and before the contract is concluded, must be true. If it be untrue the insurer may avoid the contract.

(2) A representation is material which would influence the judgment of a prudent insurer in fixing the premium, or determining whether he will take the risk.

(3) A representation may be either a representation as to a matter of fact, or as to a matter of expectation or belief.

(4) A representation as to matter of fact is true, if it be substantially correct, that is to say, if the difference between what is represented and what is actually correct would not be considered material by a prudent insurer.

(5) A representation as to a matter of expectation or belief is true if it be made in good faith.

(6) A representation may be withdrawn or corrected before the contract is concluded.

(7) Whether a particular representation be material or not is, in each case, a question of fact.

[(8) This section does not apply in relation to a contract of marine insurance if it is a consumer insurance contract within the meaning of the Consumer Insurance (Disclosure and Representations) Act 2012.]

21 When contract is deemed to be concluded

A contract of marine insurance is deemed to be concluded when the proposal of the assured is accepted by the insurer, whether the policy be then issued or not; and, for the purpose of showing when the proposal was accepted, reference may be made to the slip or covering note or other customary memorandum of the contract, . . .

The Policy

22 Contract must be embodied in policy

Subject to the provisions of any statute, a contract of marine insurance is inadmissible in evidence unless it is embodied in a marine policy in accordance with this Act. The policy may be executed and issued either at the time when the contract is concluded, or afterwards.

23 What policy must specify

A marine policy must specify--

(1) The name of the assured, or of some person who effects the insurance on his behalf:

(2)-(5) . . .

24 Signature of insurer

(1) A marine policy must be signed by or on behalf of the insurer, provided that in the case of a corporation the corporate seal may be sufficient, but nothing in this section shall be construed as requiring the subscription of a corporation to be under seal.

(2) Where a policy is subscribed by or on behalf of two or more insurers, each subscription, unless the contrary be expressed, constitutes a distinct contract with the assured.

25 Voyage and time policies

(1) Where the contract is to insure the subject-matter "at and from", or from one place to another or others, the policy is called a "voyage policy", and where the contract is to insure the subject-matter for a definite period of time the policy is called a "time policy". A contract for both voyage and time may be included in the same policy.

(2) . . .

26 Designation of subject-matter

(1) The subject-matter insured must be designated in a marine policy with reasonable certainty.

(2) The nature and extent of the interest of the assured in the subject-matter insured need not be specified in the policy.

(3) Where the policy designates the subject-matter insured in general terms, it shall be construed to apply to the interest intended by the assured to be covered.

(4) In the application of this section regard shall be had to any usage regulating the designation of the subject-matter insured.

27 Valued policy

(1) A policy may be either valued or unvalued.

(2) A valued policy is a policy which specifies the agreed value of the subject-matter insured.

(3) Subject to the provisions of this Act, and in the absence of fraud, the value fixed by the policy is, as between the insurer and assured, conclusive of the insurable value of the subject intended to be insured, whether the loss be total or partial.

(4) Unless the policy otherwise provides, the value fixed by the policy is not conclusive for the purpose of determining whether there has been a constructive total loss.

28 Unvalued policy

An unvalued policy is a policy which does not specify the value of the subject-matter insured, but, subject to the limit of the sum insured, leaves the insurable value to be subsequently ascertained, in the manner herein-before specified.

29 Floating policy by ship or ships

(1) A floating policy is a policy which describes the insurance in general terms, and leaves the name of the ship or ships and other particulars to be defined by subsequent declaration.

(2) The subsequent declaration or declarations may be made by indorsement on the policy, or in other customary manner.

(3) Unless the policy otherwise provides, the declarations must be made in the order of dispatch or shipment. They must, in the case of goods, comprise all consignments within the terms of the policy, and the value of the goods or other property must be honestly stated, but an omission or erroneous declaration may be rectified even after loss or arrival, provided the omission or declaration was made in good faith.

(4) Unless the policy otherwise provides, where a declaration of value is not made until after notice of loss or arrival, the policy must be treated as an unvalued policy as regards the subject-matter of that declaration.

30 Construction of terms in policy

(1) A policy may be in the form in the First Schedule to this Act.

(2) Subject to the provisions of this Act, and unless the context of the policy otherwise requires, the terms and expressions mentioned in the First Schedule to this Act shall be construed as having the scope and meaning in that schedule assigned to them.

31 Premium to be arranged

(1) Where an insurance is effected at a premium to be arranged, and no arrangement is made, a reasonable premium is payable.

(2) Where an insurance is effected on the terms that an additional premium is to be arranged in a given event, and that event happens but no arrangement is made, then a reasonable additional premium is payable.

Double Insurance

32 Double insurance

(1) Where two or more policies are effected by or on behalf of the assured on the same adventure and interest or any part thereof, and the sums insured exceed the indemnity allowed by this Act, the assured is said to be over-insured by double insurance.

(2) Where the assured is over-insured by double insurance--

(a) The assured, unless the policy otherwise provides, may claim payment from the insurers in such order as he may think fit, provided that he is not entitled to receive any sum in excess of the indemnity allowed by this Act;

(b) Where the policy under which the assured claims is a valued policy, the assured must give credit as against the valuation for any sum received by him under any other policy without regard to the actual value of the subject-matter insured;

(c) Where the policy under which the assured claims is an unvalued policy he must give credit, as against the full insurable value, for any sum received by him under any other policy;

(d) Where the assured receives any sum in excess of the indemnity allowed by this Act, he is deemed to hold such sum in trust for the insurers, according to their right of contribution among themselves.

Warranties, etc

33 Nature of warranty

(1) A warranty, in the following sections relating to warranties, means a promissory warranty, that is to say, a warranty by which the assured undertakes that some particular thing shall or shall not be done, or that some condition shall be fulfilled, or whereby he affirms or negatives the existence of a particular state of facts.

(2) A warranty may be express or implied.

(3) A warranty, as above defined, is a condition which must be exactly complied with, whether it be material to the risk or not. If it be not so complied with, then, subject to any express provision in the policy, the insurer is discharged from liability as from the date of the breach of warranty, but without prejudice to any liability incurred by him before that date.

34 When breach of warranty excused

(1) Non-compliance with a warranty is excused when, by reason of a change of circumstances, the warranty ceases to be applicable to the circumstances of the contract, or when compliance with the warranty is rendered unlawful by any subsequent law.

(2) Where a warranty is broken, the assured cannot avail himself of the defence that the breach has been remedied, and the warranty complied with, before loss.

(3) A breach of warranty may be waived by the insurer.

35 Express warranties

(1) An express warranty may be in any form of words from which the intention to warrant is to be inferred.

(2) An express warranty must be included in, or written upon, the policy, or must be contained in some document incorporated by reference into the policy.

(3) An express warranty does not exclude an implied warranty, unless it be inconsistent therewith.

36 Warranty of neutrality

(1) Where insurable property, whether ship or goods, is expressly warranted neutral, there is an implied condition that the property shall have a neutral character at the commencement of the risk, and that, so far as the assured can control the matter, its neutral character shall be preserved during the risk.

(2) Where a ship is expressly warranted "neutral" there is also an implied condition that, so far as the assured can control the matter, she shall be properly documented, that is to say, that she shall carry the necessary papers to establish her neutrality, and

that she shall not falsify or suppress her papers, or use simulated papers. If any loss occurs through breach of this condition, the insurer may avoid the contract.

37 No implied warranty of nationality

There is no implied warranty as to the nationality of a ship, or that her nationality shall not be changed during the risk.

38 Warranty of good safety

Where the subject-matter insured is warranted "well" or "in good safety" on a particular day, it is sufficient if it be safe at any time during that day.

39 Warranty of seaworthiness of ship

(1) In a voyage policy there is an implied warranty that at the commencement of the voyage the ship shall be seaworthy for the purpose of the particular adventure insured.

(2) Where the policy attaches while the ship is in port, there is also an implied warranty that she shall, at the commencement of the risk, be reasonably fit to encounter the ordinary perils of the port.

(3) Where the policy relates to a voyage which is performed in different stages, during which the ship requires different kinds of or further preparation or equipment, there is an implied warranty that at the commencement of each stage the ship is seaworthy in respect of such preparation or equipment for the purposes of that stage.

(4) A ship is deemed to be seaworthy when she is reasonably fit in all respects to encounter the ordinary perils of the seas of the adventure insured.

(5) In a time policy there is no implied warranty that the ship shall be seaworthy at any stage of the adventure, but where, with the privity of the assured, the ship is sent to sea in an unseaworthy state, the insurer is not liable for any loss attributable to unseaworthiness.

40 No implied warranty that goods are seaworthy

(1) In a policy on goods or other moveables there is no implied warranty that the goods or moveables are seaworthy.

(2) In a voyage policy on goods or other moveables there is an implied warranty that at the commencement of the voyage the ship is not only seaworthy as a ship, but also that she is reasonably fit to carry the goods or other moveables to the destination contemplated by the policy.

41 Warranty of legality

There is an implied warranty that the adventure insured is a lawful one, and that, so far as the assured can control the matter, the adventure shall be carried out in a lawful manner.

The Voyage

42 Implied condition as to commencement of risk

(1) Where the subject-matter is insured by a voyage policy "at and from" or "from" a particular place, it is not necessary that the ship should be at that place when the contract is concluded, but there is an implied condition that the adventure shall be commenced within a reasonable time, and that if the adventure be not so commenced the insurer may avoid the contract.

(2) The implied condition may be negatived by showing that the delay was caused by circumstances known to the insurer before the contract was concluded, or by showing that he waived the condition.

43 Alteration of port of departure

Where the place of departure is specified by the policy, and the ship instead of sailing from that place sails from any other place, the risk does not attach.

44 Sailing for different destination

Where the destination is specified in the policy, and the ship, instead of sailing for that destination, sails for any other destination, the risk does not attach.

45 Change of voyage

(1) Where, after the commencement of the risk, the destination of the ship is voluntarily changed from the destination contemplated by the policy, there is said to be a change of voyage.

(2) Unless the policy otherwise provides, where there is a change of voyage, the insurer is discharged from liability as from the time of change, that is to say, as from the time when the determination to change it is manifested; and it is immaterial that the ship may not in fact have left the course of voyage contemplated by the policy when the loss occurs.

46 Deviation

(1) Where a ship, without lawful excuse, deviates from the voyage contemplated by the policy, the insurer is discharged from liability as from the time of deviation, and it is immaterial that the ship may have regained her route before any loss occurs.

(2) There is a deviation from the voyage contemplated by the policy--

(a) Where the course of the voyage is specifically designated by the policy, and that course is departed from; or

(b) Where the course of the voyage is not specifically designated by the policy, but the usual and customary course is departed from.

(3) The intention to deviate is immaterial; there must be a deviation in fact to discharge the insurer from his liability under the contract.

47 Several ports of discharge

(1) Where several ports of discharge are specified by the policy, the ship may proceed to all or any of them, but, in the absence of any usage or sufficient cause to the contrary, she must proceed to them, or such of them as she goes to, in the order designated by the policy. If she does not there is a deviation.

(2) Where the policy is to "ports of discharge", within a given area, which are not named, the ship must, in the absence of any usage or sufficient cause to the contrary, proceed to them, or such of them as she goes to, in their geographical order. If she does not there is a deviation.

48 Delay in voyage

In the case of a voyage policy, the adventure insured must be prosecuted throughout its course with reasonable dispatch, and, if without lawful excuse it is not so prosecuted, the insurer is discharged from liability as from the time when the delay became unreasonable.

49 Excuses for deviation or delay

(1) Deviation or delay in prosecuting the voyage contemplated by the policy is excused--

(a) Where authorised by any special term in the policy; or

(b) Where caused by circumstances beyond the control of the master and his employer; or

(c) Where reasonably necessary in order to comply with an express or implied warranty; or

(d) Where reasonably necessary for the safety of the ship or subject-matter insured; or

(e) For the purpose of saving human life, or aiding a ship in distress where human life may be in danger; or

(f) Where reasonably necessary for the purpose of obtaining medical or surgical aid for any person on board the ship; or

(g) Where caused by the barratrous conduct of the master or crew, if barratry be one of the perils insured against.

(2) When the cause excusing the deviation or delay ceases to operate, the ship must resume her course, and prosecute her voyage, with reasonable dispatch.

Assignment of Policy

50 When and how policy is assignable

(1) A marine policy is assignable unless it contains terms expressly prohibiting assignment. It may be assigned either before or after loss.

(2) Where a marine policy has been assigned so as to pass the beneficial interest in such policy, the assignee of the policy is entitled to sue thereon in his own name; and the defendant is entitled to make any defence arising out of the contract which he would have been entitled to make if the action had been brought in the name of the person by or on behalf of whom the policy was effected.

(3) A marine policy may be assigned by indorsement thereon or in other customary manner.

51 Assured who has no interest cannot assign

Where the assured has parted with or lost his interest in the subject-matter insured, and has not, before or at the time of so doing, expressly or impliedly agreed to assign the policy, any subsequent assignment of the policy is inoperative:

Provided that nothing in this section affects the assignment of a policy after loss.

The Premium

52 When premium payable

Unless otherwise agreed, the duty of the assured or his agent to pay the premium, and the duty of the insurer to issue the policy to the assured or his agent, are concurrent

conditions, and the insurer is not bound to issue the policy until payment or tender of the premium.

53 Policy effected through broker

(1) Unless otherwise agreed, where a marine policy is effected on behalf of the assured by a broker, the broker is directly responsible to the insurer for the premium, and the insurer is directly responsible to the assured for the amount which may be payable in respect of losses, or in respect of returnable premium.

(2) Unless otherwise agreed, the broker has, as against the assured, a lien upon the policy for the amount of the premium and his charges in respect of effecting the policy; and, where he has dealt with the person who employs him as a principal, he has also a lien on the policy in respect of any balance on any insurance account which may be due to him from such person, unless when the debt was incurred he had reason to believe that such person was only an agent.

54 Effect of receipt on policy Where a marine policy effected on behalf of the assured by a broker acknowledges the receipt of the premium, such acknowledgment is, in the absence of fraud, conclusive as between the insurer and the assured, but not as between the insurer and broker.

Loss and Abandonment

55 Included and excluded losses

(1) Subject to the provisions of this Act, and unless the policy otherwise provides, the insurer is liable for any loss proximately caused by a peril insured against, but, subject as aforesaid, he is not liable for any loss which is not proximately caused by a peril insured against.

(2) In particular,--

(a) The insurer is not liable for any loss attributable to the wilful misconduct of the assured, but, unless the policy otherwise provides, he is liable for any loss proximately caused by a peril insured against, even though the loss would not have happened but for the misconduct or negligence of the master or crew;

(b) Unless the policy otherwise provides, the insurer on ship or goods is not liable for any loss proximately caused by delay, although the delay be caused by a peril insured against;

(c) Unless the policy otherwise provides, the insurer is not liable for ordinary wear and tear, ordinary leakage and breakage, inherent vice or nature of the subject-

matter insured, or for any loss proximately caused by rats or vermin, or for any injury to machinery not proximately caused by maritime perils.

56 Partial and total loss

(1) A loss may be either total or partial. Any loss other than a total loss, as hereinafter defined, is a partial loss.

(2) A total loss may be either an actual total loss, or a constructive total loss.

(3) Unless a different intention appears from the terms of the policy, an insurance against total loss includes a constructive, as well as an actual, total loss.

(4) Where the assured brings an action for a total loss and the evidence proves only a partial loss, he may, unless the policy otherwise provides, recover for a partial loss.

(5) Where goods reach their destination in specie, but by reason of obliteration of marks, or otherwise, they are incapable of identification, the loss, if any, is partial, and not total.

57 Actual total loss

(1) Where the subject-matter insured is destroyed, or so damaged as to cease to be a thing of the kind insured, or where the assured is irretrievably deprived thereof, there is an actual total loss.

(2) In the case of an actual total loss no notice of abandonment need be given.

58 Missing ship

Where the ship concerned in the adventure is missing, and after the lapse of a reasonable time no news of her has been received, an actual total loss may be presumed.

59 Effect of transhipment, etc

Where, by a peril insured against, the voyage is interrupted at an intermediate port or place, under such circumstances as, apart from any special stipulation in the contract of affreightment, to justify the master in landing and re-shipping the goods or other moveables, or in transhipping them, and sending them on to their destination, the liability of the insurer continues, notwithstanding the landing or transhipment.

60 Constructive total loss defined

(1) Subject to any express provision in the policy, there is a constructive total loss where the subject-matter insured is reasonably abandoned on account of its actual total loss appearing to be unavoidable, or because it could not be preserved from actual total loss without an expenditure which would exceed its value when the expenditure had been incurred.

(2) In particular, there is a constructive total loss--

(i) Where the assured is deprived of the possession of his ship or goods by a peril insured against, and *(a)* it is unlikely that he can recover the ship or goods, as the case may be, or *(b)* the cost of recovering the ship or goods, as the case may be, would exceed their value when recovered; or

(ii) In the case of damage to a ship, where she is so damaged by a peril insured against that the cost of repairing the damage would exceed the value of the ship when repaired.

In estimating the cost of repairs, no deduction is to be made in respect of general average contributions to those repairs payable by other interests, but account is to be taken of the expense of future salvage operations and of any future general average contributions to which the ship would be liable if repaired; or

(iii) In the case of damage to goods, where the cost of repairing the damage and forwarding the goods to their destination would exceed their value on arrival.

61 Effect of constructive total loss

Where there is a constructive total loss the assured may either treat the loss as a partial loss, or abandon the subject-matter insured to the insurer and treat the loss as if it were an actual total loss.

62 Notice of abandonment

(1) Subject to the provisions of this section, where the assured elects to abandon the subject-matter insured to the insurer, he must give notice of abandonment. If he fails to do so the loss can only be treated as a partial loss.

(2) Notice of abandonment may be given in writing, or by word of mouth, or partly in writing and partly by word of mouth, and may be given in terms which indicate the intention of the assured to abandon his insured interest in the subject-matter insured unconditionally to the insurer.

(3) Notice of abandonment must be given with reasonable diligence after the receipt of reliable information of the loss, but where the information is of a doubtful character the assured is entitled to a reasonable time to make inquiry.

(4) Where notice of abandonment is properly given, the rights of the assured are not prejudiced by the fact that the insurer refuses to accept the abandonment.

(5) The acceptance of an abandonment may be either express or implied from the conduct of the insurer. The mere silence of the insurer after notice is not an acceptance.

(6) Where a notice of abandonment is accepted the abandonment is irrevocable. The acceptance of the notice conclusively admits liability for the loss and the sufficiency of the notice.

(7) Notice of abandonment is unnecessary where, at the time when the assured receives information of the loss, there would be no possibility of benefit to the insurer if notice were given to him.

(8) Notice of abandonment may be waived by the insurer.

(9) Where an insurer has re-insured his risk, no notice of abandonment need be given by him.

63 Effect of abandonment

(1) Where there is a valid abandonment the insurer is entitled to take over the interest of the assured in whatever may remain of the subject-matter insured, and all proprietary rights incidental thereto.

(2) Upon the abandonment of a ship, the insurer thereof is entitled to any freight in course of being earned, and which is earned by her subsequent to the casualty causing the loss, less the expenses of earning it incurred after the casualty; and, where the ship is carrying the owner's goods, the insurer is entitled to a reasonable remuneration for the carriage of them subsequent to the casualty causing the loss.

Partial Losses (including Salvage and General Average and Particular Charges)

64 Particular average loss

(1) A particular average loss is a partial loss of the subject-matter insured, caused by a peril insured against, and which is not a general average loss.

(2) Expenses incurred by or on behalf of the assured for the safety or preservation of the subject-matter insured, other than general average and salvage charges, are called particular charges. Particular charges are not included in particular average.

65 Salvage charges

(1) Subject to any express provision in the policy, salvage charges incurred in preventing a loss by perils insured against may be recovered as a loss by those perils.

(2) "Salvage charges" means the charges recoverable under maritime law by a salvor independently of contract. They do not include the expenses of services in the nature of salvage rendered by the assured or his agents, or any person employed for hire by them, for the purpose of averting a peril insured against. Such expenses, where properly incurred, may be recovered as particular charges or as a general average loss, according to the circumstances under which they were incurred.

66 General average loss

(1) A general average loss is a loss caused by or directly consequential on a general average act. It includes a general average expenditure as well as a general average sacrifice.

(2) There is a general average act where any extraordinary sacrifice or expenditure is voluntarily and reasonably made or incurred in time of peril for the purpose of preserving the property imperilled in the common adventure.

(3) Where there is a general average loss, the party on whom it falls is entitled, subject to the conditions imposed by maritime law, to a rateable contribution from the other parties interested, and such contribution is called a general average contribution.

(4) Subject to any express provision in the policy, where the assured has incurred a general average expenditure, he may recover from the insurer in respect of the proportion of the loss which falls upon him; and, in the case of a general average sacrifice, he may recover from the insurer in respect of the whole loss without having enforced his right of contribution from the other parties liable to contribute.

(5) Subject to any express provision in the policy, where the assured has paid, or is liable to pay, a general average contribution in respect of the subject insured, he may recover therefor from the insurer.

(6) In the absence of express stipulation, the insurer is not liable for any general average loss or contribution where the loss was not incurred for the purpose of avoiding, or in connexion with the avoidance of, a peril insured against.

(7) Where ship, freight, and cargo, or any two of those interests, are owned by the same assured, the liability of the insurer in respect of general average losses or contributions is to be determined as if those subjects were owned by different persons.

Measure of Indemnity

67 Extent of liability of insurer for loss

(1) The sum which the assured can recover in respect of a loss on a policy by which he is insured, in the case of an unvalued policy to the full extent of the insurable value, or, in the case of a valued policy to the full extent of the value fixed by the policy, is called the measure of indemnity.

(2) Where there is a loss recoverable under the policy, the insurer, or each insurer if there be more than one, is liable for such proportion of the measure of indemnity as the amount of his subscription bears to the value fixed by the policy in the case of a valued policy, or to the insurable value in the case of an unvalued policy.

68 Total loss

Subject to the provisions of this Act and to any express provision in the policy, where there is a total loss of the subject-matter insured,--

(1) If the policy be a valued policy, the measure of indemnity is the sum fixed by the policy:

(2) If the policy be an unvalued policy, the measure of indemnity is the insurable value of the subject-matter insured.

69 Partial loss of ship

Where a ship is damaged, but is not totally lost, the measure of indemnity, subject to any express provision in the policy, is as follows:--

(1) Where the ship has been repaired, the assured is entitled to the reasonable cost of the repairs, less the customary deductions, but not exceeding the sum insured in respect of any one casualty:

(2) Where the ship has been only partially repaired, the assured is entitled to the reasonable cost of such repairs, computed as above, and also to be indemnified for the reasonable depreciation, if any, arising from the unrepaired damage, provided that the aggregate amount shall not exceed the cost of repairing the whole damage, computed as above:

(3) Where the ship has not been repaired, and has not been sold in her damaged state during the risk, the assured is entitled to be indemnified for the reasonable depreciation arising from the unrepaired damage, but not exceeding the reasonable cost of repairing such damage, computed as above.

70 Partial loss of freight

Subject to any express provision in the policy, where there is a partial loss of freight, the measure of indemnity is such proportion of the sum fixed by the policy in the case of a valued policy, or of the insurable value in the case of an unvalued policy, as the proportion of freight lost by the assured bears to the whole freight at the risk of the assured under the policy.

71 Partial loss of goods, merchandise, etc

Where there is a partial loss of goods, merchandise, or other moveables, the measure of indemnity, subject to any express provision in the policy, is as follows:--

(1) Where part of the goods, merchandise or other moveables insured by a valued policy is totally lost, the measure of indemnity is such proportion of the sum fixed by the policy as the insurable value of the part lost bears to the insurable value of the whole, ascertained as in the case of an unvalued policy:

(2) Where part of the goods, merchandise, or other moveables insured by an unvalued policy is totally lost, the measure of indemnity is the insurable value of the part lost, ascertained as in case of total loss:

(3) Where the whole or any part of the goods or merchandise insured has been delivered damaged at its destination, the measure of indemnity is such proportion of the sum fixed by the policy in the case of a valued policy, or of the insurable value in the case of an unvalued policy, as the difference between the gross sound and damaged values at the place of arrival bears to the gross sound value:

(4) "Gross value" means the wholesale price or, if there be no such price, the estimated value, with, in either case, freight, landing charges, and duty paid beforehand; provided that, in the case of goods or merchandise customarily sold in bond, the bonded price is deemed to be the gross value. "Gross proceeds" means the actual price obtained at a sale where all charges on sale are paid by the sellers.

72 Apportionment of valuation

(1) Where different species of property are insured under a single valuation, the valuation must be apportioned over the different species in proportion to their respective insurable values, as in the case of an unvalued policy. The insured value of any part of a species is such proportion of the total insured value of the same as the insurable value of the part bears to the insurable value of the whole, ascertained in both cases as provided by this Act.

(2) Where a valuation has to be apportioned, and particulars of the prime cost of each separate species, quality, or description of goods cannot be ascertained, the division of the valuation may be made over the net arrived sound values of the different species, qualities, or descriptions of goods.

73 General average contributions and salvage charges

(1) Subject to any express provision in the policy, where the assured has paid, or is liable for, any general average contribution, the measure of indemnity is the full amount of such contribution, if the subject-matter liable to contribution is insured for its full contributory value; but, if such subject-matter be not insured for its full contributory value, or if only part of it be insured, the indemnity payable by the insurer must be reduced in proportion to the under insurance, and where there has

been a particular average loss which constitutes a deduction from the contributory value, and for which the insurer is liable, that amount must be deducted from the insured value in order to ascertain what the insurer is liable to contribute.

(2) Where the insurer is liable for salvage charges the extent of his liability must be determined on the like principle.

74 Liabilities to third parties

Where the assured has effected an insurance in express terms against any liability to a third party, the measure of indemnity, subject to any express provision in the policy, is the amount paid or payable by him to such third party in respect of such liability.

75 General provisions as to measure of indemnity

(1) Where there has been a loss in respect of any subject-matter not expressly provided for in the foregoing provisions of this Act, the measure of indemnity shall be ascertained, as nearly as may be, in accordance with those provisions, in so far as applicable to the particular case.

(2) Nothing in the provisions of this Act relating to the measure of indemnity shall affect the rules relating to double insurance, or prohibit the insurer from disproving interest wholly or in part, or from showing that at the time of the loss the whole or any part of the subject-matter insured was not at risk under the policy.

76 Particular average warranties

(1) Where the subject-matter insured is warranted free from particular average, the assured cannot recover for a loss of part, other than a loss incurred by a general average sacrifice unless the contract contained in the policy be apportionable; but, if the contract be apportionable, the assured may recover for a total loss of any apportionable part.

(2) Where the subject-matter insured is warranted free from particular average, either wholly or under a certain percentage, the insurer is nevertheless liable for salvage charges, and for particular charges and other expenses properly incurred pursuant to the provisions of the suing and labouring clause in order to avert a loss insured against.

(3) Unless the policy otherwise provides, where the subject-matter insured is warranted free from particular average under a specified percentage, a general average loss cannot be added to a particular average loss to make up the specified percentage.

(4) For the purpose of ascertaining whether the specified percentage has been reached, regard shall be had only to the actual loss suffered by the subject-matter insured. Particular charges and the expenses of and incidental to ascertaining and proving the loss must be excluded.

77 Successive losses

(1) Unless the policy otherwise provides, and subject to the provisions of this Act, the insurer is liable for successive losses, even though the total amount of such losses may exceed the sum insured.

(2) Where, under the same policy, a partial loss, which has not been repaired or otherwise made good, is followed by a total loss, the assured can only recover in respect of the total loss:

Provided that nothing in this section shall affect the liability of the insurer under the suing and labouring clause.

78 Suing and labouring clause

(1) Where the policy contains a suing and labouring clause, the engagement thereby entered into is deemed to be supplementary to the contract of insurance, and the assured may recover from the insurer any expenses properly incurred pursuant to the clause, notwithstanding that the insurer may have paid for a total loss, or that the subject-matter may have been warranted free from particular average, either wholly or under a certain percentage.

(2) General average losses and contributions and salvage charges, as defined by this Act, are not recoverable under the suing and labouring clause.

(3) Expenses incurred for the purpose of averting or diminishing any loss not covered by the policy are not recoverable under the suing and labouring clause.

(4) It is the duty of the assured and his agents, in all cases, to take such measures as may be reasonable for the purpose of averting or minimising a loss.

Rights of Insurer on Payment

79 Right of subrogation

(1) Where the insurer pays for a total loss, either of the whole, or in the case of goods of any apportionable part, of the subject-matter insured, he thereupon becomes entitled to take over the interest of the assured in whatever may remain of the subject-matter so paid for, and he is thereby subrogated to all the rights and remedies of the assured in and in respect of that subject-matter as from the time of the casualty causing the loss.

(2) Subject to the foregoing provisions, where the insurer pays for a partial loss, he acquires no title to the subject-matter insured, or such part of it as may remain, but he is thereupon subrogated to all rights and remedies of the assured in and in respect of the subject-matter insured as from the time of the casualty causing the loss, in so far as the assured has been indemnified, according to this Act, by such payment for the loss.

80 Right of contribution

(1) Where the assured is over-insured by double insurance, each insurer is bound, as between himself and the other insurers, to contribute rateably to the loss in proportion to the amount for which he is liable under his contract.

(2) If any insurer pays more than his proportion of the loss, he is entitled to maintain an action for contribution against the other insurers, and is entitled to the like remedies as a surety who has paid more than his proportion of the debt.

81 Effect of under insurance

Where the assured is insured for an amount less than the insurable value or, in the case of a valued policy, for an amount less than the policy valuation, he is deemed to be his own insurer in respect of the uninsured balance.

Return of Premium

82 Enforcement of return

Where the premium or a proportionate part thereof is, by this Act, declared to be returnable,--

(a) If already paid, it may be recovered by the assured from the insurer; and

(b) If unpaid, it may be retained by the assured or his agent.

83 Return by agreement

Where the policy contains a stipulation for the return of the premium, or a proportionate part thereof, on the happening of a certain event, and that event happens, the premium, or, as the case may be, the proportionate part thereof, is thereupon returnable to the assured.

84 Return for failure of consideration

(1) Where the consideration for the payment of the premium totally fails, and there has been no fraud or illegality on the part of the assured or his agents, the premium is thereupon returnable to the assured.

(2) Where the consideration for the payment of the premium is apportionable and there is a total failure of any apportionable part of the consideration, a proportionate part of the premium is, under the like conditions, thereupon returnable to the assured.

(3) In particular--

(a) Where the policy is void, or is avoided by the insurer as from the commencement of the risk, the premium is returnable, provided that there has been no fraud or illegality on the part of the assured; but if the risk is not apportionable, and has once attached, the premium is not returnable;

(b) Where the subject-matter insured, or part thereof, has never been imperilled, the premium, or, as the case may be, a proportionate part thereof, is returnable:

Provided that where the subject-matter has been insured "lost or not lost" and has arrived in safety at the time when the contract is concluded, the premium is not returnable unless, at such time, the insurer knew of the safe arrival.

(c) Where the assured has no insurable interest throughout the currency of the risk, the premium is returnable, provided that this rule does not apply to a policy effected by way of gaming or wagering;

(d) Where the assured has a defeasible interest which is terminated during the currency of the risk, the premium is not returnable;

(e) Where the assured has over-insured under an unvalued policy, a proportionate part of the premium is returnable;

(f) Subject to the foregoing provisions, where the assured has over-insured by double insurance, a proportionate part of the several premiums is returnable:

Provided that, if the policies are effected at different times, and any earlier policy has at any time borne the entire risk, or if a claim has been paid on the policy in respect of the full sum insured thereby, no premium is returnable in respect of that policy, and when the double insurance is effected knowingly by the assured no premium is returnable.

Mutual Insurance

85 Modification of Act in case of mutual insurance

(1) Where two or more persons mutually agree to insure each other against marine losses there is said to be a mutual insurance.

(2) The provisions of this Act relating to the premium do not apply to mutual insurance, but a guarantee, or such other arrangement as may be agreed upon, may be substituted for the premium.

(3) The provisions of this Act, in so far as they may be modified by the agreement of the parties, may in the case of mutual insurance be modified by the terms of the policies issued by the association, or by the rules and regulations of the association.

(4) Subject to the exceptions mentioned in this section, the provisions of this Act apply to a mutual insurance.

Supplemental

86 Ratification by assured

Where a contract of marine insurance is in good faith effected by one person on behalf of another, the person on whose behalf it is effected may ratify the contract even after he is aware of a loss.

87 Implied obligations varied by agreement or usage

(1) Where any right, duty, or liability would arise under a contract of marine insurance by implication of law, it may be negatived or varied by express agreement, or by usage, if the usage be such as to bind both parties to the contract.

(2) The provisions of this section extend to any right, duty, or liability declared by this Act which may be lawfully modified by agreement.

88 Reasonable time, etc, a question of fact

Where by this Act any reference is made to reasonable time, reasonable premium, or reasonable diligence, the question what is reasonable is a question of fact.

89 Slip as evidence

Where there is a duly stamped policy, reference may be made, as heretofore, to the slip or covering note, in any legal proceeding.

90 Interpretation of terms

In this Act, unless the context or subject-matter otherwise requires,--

"Action" includes counter-claim and set off:

"Freight" includes the profit derivable by a shipowner from the employment of his ship to carry his own goods or moveables, as well as freight payable by a third party, but does not include passage money:

"Moveables" means any moveable tangible property, other than the ship, and includes money, valuable securities, and other documents:

"Policy" means a marine policy.

91 Savings

(1) Nothing in this Act, or in any repeal effected thereby, shall affect--

(a) The provisions of the Stamp Act 1891, or any enactment for the time being in force relating to the revenue;

(b) The provisions of the Companies Act 1862, or any enactment amending or substituted for the same;

(c) The provisions of any statute not expressly repealed by this Act.

(2) The rules of the common law including the law merchant, save in so far as they are inconsistent with the express provisions of this Act, shall continue to apply to contracts of marine insurance.

92 . . .

. . .

93 . . .

. . .

94 Short title

This Act may be cited as the Marine Insurance Act 1906.

The Law Commission
Consultation Paper No 201
and
The Scottish Law Commission
Discussion Paper No 152

INSURANCE CONTRACT LAW: POST CONTRACT DUTIES AND OTHER ISSUES

A Joint Consultation Paper

This is the second consultation paper in the joint insurance law project

CHAPTER 2

INSURERS' REMEDIES FOR FRAUD

PART 6
INSURERS' REMEDIES FOR FRAUD: THE CURRENT LAW

INTRODUCTION

6.1 Fraudulent insurance claims are a serious and expensive problem. The law needs to play a robust role in deterring fraud by imposing a clear penalty on those who act dishonestly. Unfortunately, the law on the effect of a fraudulent claim is convoluted and confused. Although it is well-established that a policyholder who fraudulently exaggerates an insurance claim forfeits the whole claim, there is considerable uncertainty about the effect of a fraud on other claims made under the policy.

6.2 In July 2010 we published Issues Paper 7, *The Insured's Post-Contract Duty of Good Faith*, which examined the law in this area and invited views. We have developed our proposals in the light of the responses we received. Our aim is to clarify the law by setting out clear, practical sanctions which will have a strong deterrent effect.

The structure of this section

6.3 This section is divided into four parts:

(1) In this Part we provide an overview of the current law. We explain how the divergence between the common law and section 17 of the Marine Insurance Act 1906 has generated unnecessary disputes. A fuller account of the law is provided in Issues Paper 7.

(2) Next, in Part 7 we state the case for reform. We summarise the criticisms of the current law and the responses we received to the Issues Paper. There was general agreement that legislation was needed to clarify the insurer's remedies.

(3) In Part 8 we set out our proposals for reform. Our proposals reflect current court decisions that a fraudulent claim should be forfeited, but that the fraud should not affect previous valid claims made under a policy. Following the strong arguments put to us, however, we propose that a fraud should discharge an insurer from future liabilities. Thus an insurer would not be obliged to pay any claim which arises following a fraud, whether or not it has taken action to terminate the contract. We also propose a new, but limited, liability on fraudsters to pay for insurers' reasonable and legitimate costs in investigating fraudulent claims.

(4) In Part 9 we consider the specific problems of joint insurance and group insurance schemes. We look at whether there is a need to protect an innocent policyholder where another joint policyholder has committed fraud. We also consider the anomalous position which arises where a member commits fraud whilst being a member of a group scheme. It would appear that because members are not policyholders the normal deterrents do not apply to them. We propose to remedy this defect.

ISSUES NOT COVERED

6.4 We do not deal with the criminal law. In England and Wales, a policyholder who dishonestly makes a false representation with the intention of making a gain commits an offence under section 2 of the Fraud Act 2006.[1] In Scotland, the common law offence of fraud is committed by bringing about a practical result by means of a false pretence.[2] However, prosecutions for this type of fraud are rare. This means that the civil remedies play an important part in deterring fraud, and are the focus of this reform.

6.5 Nor do we consider the definition of fraud. In Issues Paper 7 we discussed fraud and suggested that fraud can be thought of as a range of behaviours. We also discussed the main cases and we noted that the exact definition of fraud is not always clear-cut; we think this arises from the nature of the issue. We therefore concluded that the definition of fraud was best left to the courts. Dishonesty is a malleable and evolving concept, and we did not wish to interfere with the flexibility which courts require to identify fraud. Most consultees (20 out of 24) agreed, and we are therefore not proposing change in this area.

THE NEED FOR DETERRENCE

6.6 Insurers are particularly vulnerable to fraud, as policyholders are often the only people fully aware of the circumstances of a loss. The evidence suggests that fraudulent claims are a significant problem. The Association of British Insurers (ABI) reports that in 2010 insurers uncovered 133,000 fraudulent claims. The value of these claims totalled £919 million or 5% of the value of all claims made on its members that year. Insurance fraud is said to cost the UK economy £2 billion every year.[3]

6.7 If a claim is made in the absence of a genuine loss, then clearly the insurer is not required to pay the claim. However, the law has long recognised that a fraudster should risk more than the non-payment of the fraudulent part of the claim. The point was put forcefully in 1866 in *Britton v Royal Insurance Co*:

> It would be most dangerous to permit parties to practise such frauds, and then, notwithstanding their falsehood and fraud, to recover the real value of the goods consumed.[4]

1 Under s 3, it is also an offence to dishonestly fail to disclose information which one is under a legal duty to disclose.

2 The common law offence of attempted fraud is committed where the false pretence does not cause a practical result. See *The Laws of Scotland (Stair Memorial Encyclopaedia)*, Criminal Law (Reissue), para 364.

3 Association of British Insurers, News Release 31/11 (28 July 2011) available at http://www.abi.org.uk/Media/Releases/2011/07/You_could_not_make_it_up_but_some_did_Insurers_detecting_more_fraudulent_claims_than_ever_over_2500_worth_18_million_every_week.aspx

4 (1866) 4 F&F 905, at 909.

Forfeiting the claim

6.8 Since the nineteenth century, the courts have held that a person who fraudulently exaggerates a claim forfeits the whole claim. This does not depend on an express term of the contract, but is said to be a common law rule.[5]

6.9 An example of this principle is *Galloway v Guardian Royal Exchange (UK) Ltd.*[6] Mr Galloway was burgled and suffered a genuine loss of around £16,000. When he submitted his claim, however, he fabricated a claim for a fictitious computer for around £2,000. The Court of Appeal rejected the whole claim, including the £16,000 of genuine loss. Lord Justice Millett noted:

> There seems to be a widespread belief that insurance companies are fair game, and that defrauding them is not morally reprehensible. The rule which we are asked to enforce today may appear to some to be harsh, but it is in my opinion a necessary and salutary rule which deserves to be better known by the public.

6.10 We agree that it is important that fraudsters should face due sanctions. It is also important that, if the sanction is to have a deterrent effect, it is clear and well- known. As we discuss below, however, there are some unhelpful ambiguities in the law.

Section 17 of the Marine Insurance Act 1906

6.11 The central problem is the mismatch between the common law rule and the duty of good faith, as set out in section 17 of the 1906 Act. The section states:

> 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.

6.12 The duty has been held to apply to all types of insurance.

6.13 Section 17 specifies only one remedy for failing to observe utmost good faith: avoidance of the contract. This means avoiding the contract from the start, that is, returning the parties to the position in which they would be had the contract never existed. In theory, insurers could require policyholders to repay all claims which had been paid under the policy, including genuine and legitimate claims finalised and paid before the fraud arose.

6.14 In practice, the courts have been reluctant to allow insurers to recoup valid claims which arise before the fraud took place. Finality is a core value of law in the UK: if a valid claim is paid under a valid contract, it seems wrong to attempt to overturn that payment on the basis of subsequent events.

[5] For an analysis of the 19th century cases, see Lord Hobhouse, *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd and Others (The Star Sea)* [2001] UKLH 1, [2003] AC 469 at [62]-[67].

[6] [1999] Lloyd's Rep IR 209.

6.15 The courts have sought to escape the conclusion that the remedy for fraudulent claims is avoidance of the contract, but at the cost of convoluted reasoning and uncertainty.

6.16 In the absence of an express term, the common law will apply. Below we start with a discussion on express terms and then consider the definition in common law.

EXPRESS TERMS

6.17 Many insurance policies include express terms setting out the consequences of fraud. The courts are usually willing to enforce such terms. Indeed, it has been held that since fraud clauses are common, there is no need to bring the clause to the insured's specific attention.[7]

6.18 An example in which a fraud clause was upheld is *Joseph Fielding Properties v Aviva Insurance*.[8] The policy stated that in the event of fraud:

> We will at our option avoid the policy from the inception of this insurance or from the date of the claim or alleged claim or avoid the claim.[9]

6.19 After a fire broke out on the insured's premises, JFP notified a claim to Aviva for over £2 million. Aviva sought to avoid on two grounds. Firstly, during the term of the current policy, JFP had made a previous fraudulent claim relating to drainage for nearly £10,000. Secondly, Aviva alleged that JFP had failed to disclose at inception that its principal shareholders had made fraudulent claims and misrepresentations to other insurers in the past.

6.20 The court concluded that each of Aviva's allegations were true. Aviva conceded that "if it could rely only upon fraud at common-law then it could not recoup the monies paid out"[10] on previously genuine claims. However, Judge Waksman QC held that this point was "academic". It was not necessary to consider the common law position as the express fraudulent claims clause applied:

> Whatever the common-law position might have been is irrelevant since Aviva has invoked an express condition of the policy whose meaning is clear – Aviva "may avoid the policy from inception".[11]

[7] *Nsubuga v Commercial Union Assurance* [1998] 2 Lloyd's Rep 682, at 686.

[8] [2010] EWHC 2192, [2011] Lloyd's Rep IR 238.

[9] Above, at [15].

[10] Above, at [97].

[11] Above, at [96].

6.21 That said, the clause must be clear and unambiguous. In *Fargnoli v GA Bonus Plc,*[12] Lord Penrose held that the words "all benefit under the policy shall be forfeited" were ambiguous. They could apply to all benefit in respect of the claim, or all benefit in respect of the policy as a whole. He therefore applied the "*contra proferentem*" rule, which means that a clause should be construed against the party who puts it forward. On this basis, he decided that the words meant that only the claim to which the fraud related should be forfeited.

6.22 In consumer insurance contracts, a fraud clause would be subject to the Unfair Terms in Consumer Contracts Regulations 1999. Consumers would also have recourse to the Financial Ombudsman Service (FOS). The FOS has issued guidance on how it would deal with fraudulent claims, making clear that an insurer's remedy is not avoidance but forfeiture:

> The insurer is not obliged to pay the fraudulent claim and it can cancel the policy prospectively.[13]

6.23 This means that while a clause permitting an insurer to avoid the whole contract can apply in business insurance, it may be more difficult to apply such a clause against a consumer.

Excluding liability for fraud

6.24 In the unlikely event that an insurer agreed to a clause which excluded the policyholder's liability for fraud, would this be valid? The courts have held that it would not be.[14] There is, however, some doubt about whether it might be possible for a policyholder to exclude liability for fraud by their agent. In Issues Paper 7 we asked whether this should be clarified. As we discuss in Part 7, it was not thought to be a significant matter in practice.

WHERE THERE IS NO EXPRESS TERM: THE EVOLVING CASE-LAW

Early cases

6.25 Where there is no express term, the courts have struggled to provide a clear account of the appropriate remedy. Here we provide an overview of the main cases: a fuller account is provided in Issues Paper 7.

[12] 1997 SCLR 12; [1997] CLC 653; [1997] 6 Re LR 374.

[13] *Ombudsman News*, Issue 21, October 2002.

[14] *HIH Casualty & General Insurance v Chase Manhattan Bank* [2003] UKHL 6, [2003] 1 All ER (Comm) 349. In Scots law, parties may not, by virtue of contractual terms, exclude liability for fraud; see *Mair v Rio Grande Rubber Estates Ltd* 1913 SC (HL) 74, [1913] AC 853; *Boyd and Forrest v Glasgow and South Western Railway Co* 1915 SC (HL) 20, [1915] AC 526; and *H & JM Bennett (Potatoes) Ltd v Secretary of State for Scotland* 1988 SLT 390.

6.26 In 1994, the Court of Appeal held that the duty not to make a fraudulent claim was an implied term of an insurance contract.[15] This view found support in some subsequent cases.[16] It no longer appears to be good law, however, following the House of Lords decision in *The Star Sea.*[17]

6.27 Another line of cases has seen the insurer argue directly for a right of avoidance under section 17 of the 1906 Act. In *The Litsion Pride,*[18] Mr Justice Hirst held that the duty of good faith applied post-contract and at a similar level to the pre- contract duty of good faith. Again, however, this was revisited in *The Star Sea* and can no longer be considered good law.

The Star Sea: reinterpreting the post-contract duty of good faith

6.28 In 2001, in *The Star Sea,*[19] the House of Lords reinterpreted the post-contract duty of good faith, as set out in section 17 of the 1906 Act.

6.29 The case did not directly concern a fraudulent claim. Rather, the insurers argued that the insured had failed to disclose relevant material following a fire. The fire broke out in the ship's engine rooms. Attempts to extinguish it proved unsuccessful, partly because the engine room could not be sealed. Two vessels in the same fleet had suffered a similar fate, and the policyholder obtained a report into the circumstances. The insurers alleged that the policyholder had breached its duty of good faith by failing to disclose this report, which was relevant to the insurer's argument that the owners knew the ship to be unseaworthy.

6.30 The House of Lords limited the duty of good faith in two ways. First, the duty of good faith did not continue once legal proceedings had begun. Once a writ was issued, the parties' duties were governed by the rules of court procedure, which set out disclosure requirements and appropriate sanctions for non-compliance.

6.31 Secondly, the House of Lords distinguished between the pre-contract and post- contract duty of good faith. Whereas the duty to disclose information pre-contract was a strict one, after the contract the duty of good faith was flexible and varied according to context. As Lord Clyde put it:

[15] *Orakpo v Barclays Insurance Services Co Ltd* [1994] CLC 373.

[16] See, for example, *Royal Boskalis Westminster NV v Mountain* [1999] QB 674, [1997] LRLR 523, at 593 and 597; and *Continental Illinois National Bank v Alliance Assurance Co Ltd (The Captain Panagos D.P.)* [1986] 2 Lloyd's Rep 470, at 512.

[17] *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd and Others (The Star Sea)* [2001] UKHL 1, [2003] AC 469.

[18] See, for example, *Black King Shipping Corporation v Massie (The Litsion Pride)* [1985] 1 Lloyd's Rep 437.

[19] *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd and Others (The Star Sea)* [2001] UKHL 1, [2003] 1 AC 469.

> The idea of good faith in the context of insurance contracts reflects the degrees of openness required of the parties in the various stages of their relationship. It is not an absolute. The substance of the obligation which is entailed can vary according to the context in which the matter comes to be judged.[20]

6.32 Lord Scott noted that in the context of making a claim, all that was required was "a duty of honesty".[21] As Professor Clarke put it, "when a claim is made nothing short of fraud in the presentation of the claim will amount to a breach of the duty of disclosure and of good faith".[22]

6.33 This, however, leaves a question where the claimant does act fraudulently. If fraud is a breach of good faith, does section 17 give the insurer the right to avoid the contract? Lord Scott described this as "debateable" but refrained from deciding the point.[23]

6.34 Lord Hobhouse severely criticised the remedy of avoidance. He thought that avoidance may be appropriate where "the want of good faith has preceded and been material to the making of the contract". But, where the want of good faith occurs later, "it becomes anomalous and disproportionate". He explained:

> The insurer is able not only to treat himself as discharged from further liability but can also undo all that has perfectly properly gone before. This cannot be reconciled with principle.[24]

6.35 Lord Hobhouse noted that many traditional authorities did not use the language of avoidance, but referred to "forfeiture". Accordingly, he suggested that based on the rule of law, the appropriate remedy for fraud was the forfeiture of the claim.

6.36 Subsequent cases have attempted to apply these principles. As we will see, this has not been an easy task.

The Mercandian Continent: limiting avoidance

6.37 In *The Mercandian Continent*,[25] Lord Justice Longmore reviewed the case law, noting that avoidance is not available for every case where the policyholder breaches the duty of good faith. He observed that:

> It must have been intended by Parliament that avoidance by reason of post-contract matters should be subject at least to the same requirements as avoidance by reason of matters pre-contract.[26]

20 Above, at [7].

21 Above, at [111].

22 MA Clarke, *The Law of Insurance Contracts* (4th ed 2002), para 27-2B.

23 *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd and Others (The Star Sea)* [2001] UKHL 1, [2003] 1 AC 469, at [110].

24 Above, at [51].

25 *K/S Merc-Scandia XXXXII v Certain Lloyd's Underwriters (The Mercandian Continent)* [2001] EWCA Civ 1275, [2001] 2 Lloyd's Rep 563.

6.38 The pre-contract remedy of avoidance is available under the common law only where the insurer has satisfied the tests for materiality and inducement as set out in *Pan Atlantic v Pine Top Insurance Co.*[27] Lord Justice Longmore attempted to adapt these two tests to the claims context, finding that the conduct which is relied on by the underwriters must be causally relevant to the underwriters' ultimate liability or, at least, to some defence that may be available to the underwriters.[28] Furthermore, the insured's conduct must amount to repudiation of the contract.[29]

6.39 On the facts of the case, the insured's actions were held not to be material. Most cases of fraud, however, would pass both requirements.[30] *The Mercandian Continent* does little on its own to limit the remedy of avoidance for standard types of fraud.

The Aegeon: avoidance does not apply to fraud

6.40 In *The Aegeon (No 1),* [31] Lord Justice Mance[32] sought to make sense of the law on remedies for fraudulent claims following *The Star Sea.* He acknowledged that this was not an easy task:

> The waves of insurance litigation over the last 20 years have involved repeated examination of the scope and application of any post- contractual duty of good faith. The opacity of the relevant principles – whether originating in venerable but cryptically reasoned common law cases or enshrined, apparently immutably, in section 17 of the Marine Insurance Act 1906 – is matched only by the stringency of the sanctions assigned.[33]

6.41 He expressed "the hope that the House of Lords judicially or Parliament legislatively might one day look at the point again".[34]

[26] Above, at [26].

[27] *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* [1995] 1 AC 501.

[28] *K/S Merc-Scandia XXXXII v Certain Lloyd's Underwriters (The Mercandian Continent)* [2001] EWCA Civ 1275, [2001] 2 Lloyd's Rep 563, at [28], adopting Rix LJ's statement in *Royal Boskalis Westminster NV v Mountain* [1999] QB 674, [1997] LRLR 523 at [597] that a post-contractual breach of good faith must be ultimately legally relevant to a defence which the insurers had under the policy terms and the insurers must have been induced to change their position.

[29] Above, at [26].

[30] MacGillivray suggests that "the paradigm cases of the baseless claim, the inflated claim and the suppression of a defence" would likely pass both these versions of the materiality and inducement tests. *MacGillivray on Insurance Law* (11th ed, 2008), para 19-065.

[31] *Agapitos v Agnew (No 1) (The Aegeon)* [2002] EWCA Civ 247, [2003] QB 556.

[32] Now Lord Mance JSC.

[33] *Agapitos v Agnew (No 1) (The Aegeon)* [2002] EWCA Civ 247, [2003] QB 556 at [1].

[34] Above at [13].

6.42 In the current state of the law there are three possible approaches to the effect of section 17 on fraudulent claims. The courts could:

(1) accept a strict interpretation of section 17, and hold that avoidance was the appropriate remedy;

(2) deny that avoidance was the remedy for all breaches of the duty of good faith; or

(3) decide that making a fraudulent claim was not a breach of the duty of good faith as set out in section 17.

6.43 Lord Justice Mance tentatively opted for (3). He thought that a solution to the "present imperfect state of the law" would be to:

> treat the common law rules governing the making of a fraudulent claim (including the use of fraudulent devices) as falling outside the scope of section 17 … . On this basis no question of avoidance ab initio would arise.[35]

Instead, the common law provides a separate rule that the appropriate remedy for fraud is forfeiture of the claim.

6.44 This is a difficult analysis: it is one thing to say that only fraud breaches the insured's post-contract duty of good faith. It is another thing altogether to say that even fraud does not breach the duty.

6.45 Academics and textbook writers have also struggled to make sense of the current law. MacGillivray takes the view that there are "two separate principles of insurance law, each of which can be invoked in defence by the insurer".[36] Thus, the common law rule referred to by Lord Justice Mance exists side by side with the remedy of avoidance under section 17. The insurer can choose which to pursue.[37]

6.46 By contrast, Professor Clarke considers there to be a single doctrine: the fraudulent claim fails entirely and the insurer may terminate the contract. Past outstanding honest claims remain enforceable, however, and the insurer cannot recover insurance money paid out in respect of other claims.[38]

[35] Above, at [45]. "Ab initio" means from the start of the contract.

[36] *MacGillivray on Insurance Law* (11th ed 2008), para 19-055.

[37] This is evident in a subsequent judgment of Lord Justice Mance in which he refers to the common law principle having a separate origin and existence to any principle which exists under section 17. See *Axa General Insurance Ltd v Gottlieb* [2005] EWCA Civ 112, [2005] 1 All ER (Comm) 445, at [20].

[38] MA Clarke, *The Law of Insurance Contracts* (4th ed 2002), para 27-2C3.

Axa v Gottlieb: the insurer may not recoup previous claims

6.47 The case of *Axa General Insurance Ltd v Gottlieb*[39] lends support to Professor Clarke's view. Mr and Mrs Gottlieb claimed under a buildings insurance policy on four occasions during the policy year, and settled two claims without any issue of fraud arising. The insurer made interim payments on the other two claims before discovering that the policyholders had acted fraudulently in pursing these claims. The insurer sought to recover all the payments it had made.

6.48 The Court of Appeal held that the insurer was entitled to recover all interim payments paid in respect of the two fraudulent claims. The other two claims, however, had been paid in full, and had arisen before any fraud had occurred. These were not recoverable.

6.49 Lord Justice Mance again explained that the rule against fraudulent insurance claims was a special common law rule, distinct from section 17. Under the rule, the appropriate remedy was "to forfeit the whole of the claim to which the fraud relates". It did not affect prior separate claims, settled under the policy before the fraud occurred. He did not reach a conclusion on whether the insurer would be obliged to pay separate claims which were still unpaid at the time of the fraud. He saw some force in the argument, however, that forfeiture should be confined to the fraudulent claim.

Fargnoli: avoidance is not the appropriate remedy in Scotland

6.50 The Scottish courts appear to have achieved the same result through a different route. In *Fargnoli v GA Bonus Plc,*[40] the pursuer made a claim following a fire at his premises. The insurers alleged that the pursuer had caused, or connived in causing, a second, later fire on the same premises. They argued that this subsequent fraud should lead to the retrospective forfeiture of that first claim. The argument was rejected.

6.51 Lord Penrose distinguished pre-contract fraud (where avoidance is appropriate) from post-contract fraud. Pre-contract fraud vitiates the contract. Where there is fraud in making a claim, however, there has been "a valid binding contract" up until the date the fraudulent claim was presented to the insurer: to avoid the policy from the start "would defeat that reality".[41] Furthermore, avoidance was not an appropriate remedy for every want of good faith: the duty was mutual and the remedy was purely one sided.

6.52 Instead the remedy for fraud was forfeiture of the claim. Though "a claim tainted by fraud would be cut down as a whole", the pursuer's first claim was a valid one.[42] Thus the pursuer was entitled to have his first fire claim assessed on the merits, and that earlier claim would be unaffected by the pursuer's alleged subsequent fire-raising attempt.

[39] [2005] EWCA Civ 112, [2005] 1 All ER (Comm) 445.

[40] 1997 SCLR 12; [1997] CLC 653; [1997] 6 Re LR 374.

[41] 1997 SCLR 12, at p 30.

[42] Above.

THE EFFECT OF FRAUD ON SUBSEQUENT CLAIMS

6.53 A further question is the effect of fraud on a subsequent claim. Suppose an insured householder fabricates some aspect of a water damage claim, but the house burns down during the investigation. Does the policyholder forfeit the subsequent valid claim? There are two possible approaches:

(1) The fraud is characterised as a breach of the contract, which gives the insurer the right to terminate cover. However, the policy continues to exist until termination, and any claim arising between the date of the fraud and the date of termination must be paid.

(2) The presentation of the fraudulent claim automatically brings the contract to an end, invalidating any claim which arises after the fraud but before the fraud is discovered.

6.54 There is no definitive ruling on the issue. However, the cases suggest that the first view is favoured. Normal contractual rules apply. On this basis, the fraud amounts to a repudiatory breach of contract, permitting the insurer to terminate the contract. The contract continues, however, until the insurer has exercised its right to terminate. In *Axa General Insurance Ltd v Gottlieb*, Lord Justice Mance put the point as follows:

> There seems to me some force in the argument that the common law rule relating to fraudulent claims should be confined to the particular claim to which any fraud relates, while the potential scope and operation of more general contractual principles might in some circumstances also require consideration.[43]

6.55 In *Fargnoli v GA Bonus Plc*, Lord Penrose made a similar observation. He said that fraud would amount to a repudiatory breach of the contract, entitling the insurer to rescind in accordance with general contract principles. He added, however, that:

> rescission does not absolve parties from primary obligations already due for performance at the time of rescission.[44]

CAN THE INSURER SUE THE INSURED FOR DAMAGES?

6.56 One final question is whether an insurer can sue an insured for damages following a fraudulent claim, for example to recover the cost of investigating the claim.

6.57 The answer appears to be no. This was confirmed by *London Assurance v Clare*,[45] which held that the cost of investigation is not recoverable under an implied term not to commit fraud.

[43] [2005] EWCA Civ 112, [2005] 1 All ER (Comm) 445, at [22].

[44] 1997 SCLR 12, at p 22. Rescission is the standard Scots law term for termination of a contract for material breach. (See W W McBryde, *The Law of Contract in Scotland* (3rd ed, 2007), para 20-05). Rescission in Scots law is, generally, prospective rather than retrospective in effect. (See W W McBryde, *The Law of Contract in Scotland* (3rd ed, 2007), para 20-109).

6.58 It remains open to an insurer, however, to argue that it is entitled to claim damages for deceit following a fraudulent claim. In *Insurance Corporation of the Channel Islands Ltd v McHugh,*[46] allegations of deceit were pleaded by the insurers but not pursued at trial. If they had been, Mr Justice Mance noted that an action for deceit might have been arguable in principle.[47]

CONCLUSION

6.59 The area of controversy is relatively small. In many cases, the courts simply give effect to an express term setting out the insurer's remedies for fraud. In other cases, the insurer is only concerned with the effect of the fraud on the claim in hand: here the law is clear that the whole claim is forfeited and any interim payments made on those claims may be recouped.

6.60 There are, however, three unresolved issues:

(1) Does a fraudulent claim affect a previous claim made under the same policy?

(2) Does a fraudulent claim affect subsequent claims made before the insurer has taken action to terminate the contract?

(3) May the insurer sue the insured for damages to recover the cost of investigating a fraudulent claim?

6.61 As we have seen, these issues have generated considerable case law and debate, as the courts struggle to reconcile the apparently clear words of section 17 with principle and logic.

6.62 Although the three points of contention are relatively narrow ones, we think that reform is needed. It is common for commercial insurance policies to cover many different goods, or many different risks. For example the policy in *The Star Sea*[48] covered 33 ships. Small businesses are increasingly using combined policies, covering vehicles, property and liability. In these circumstances, the difference between forfeiting the claim and avoiding the whole policy may be significant.

6.63 Moreover, it is particularly important that the law in this area is clearly articulated and understood. The more confused the rules, the less they will deter fraud.

[45] (1937) 57 Ll L Rep 254, by Goddard J, at p 270.

[46] [1997] 1 LRLR 94.

[47] Above at 125.

[48] *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd and Others (The Star Sea)* [2001] UKHL 1, [2003] 1 AC 469.

6.64 Only Parliament can change section 17. We think it is time for statutory reform, to set out the remedies for fraud. As we explain in Parts 7 and 8, we think that fraud should lead to forfeiture of the whole claim to which the fraud relates *and* forfeiture of any subsequent claim. It should, in some circumstances, give the insurer the right to claim damages. It should not, however, affect any previous claims, whether or not they have been paid.

PART 7
INSURERS' REMEDIES FOR FRAUD: THE CASE FOR REFORM

7.1 The law on remedies for fraudulent claims is convoluted. Section 17 of the Marine Insurance Act 1906 appears to entitle an insurer to avoid the contract, and recoup any claims already paid. Yet the common law has diverged from this harsh position and holds that the appropriate remedy is forfeiture only of the fraudulent claim. This disjuncture has generated unnecessary complexity and uncertainty. In this Part we set out the case for statutory reform.

A NEW STATUTORY CODE

7.2 In Issues Paper 7 we tentatively proposed legislative reform and invited views.[1] The great majority of consultees agreed that legislation was needed to clarify this confusing area. Out of the 25 responses that addressed the question, all but four agreed that the law was unnecessarily complex. All but two thought that it would be helpful to introduce legislation to clarify the insurers' remedies.

7.3 The Association of British Insurers (ABI) acknowledged the various, conflicting ways in which fraud by the insured has been characterised. It favoured straightforward legislation:

> The duty not to make a fraudulent claim has been characterised in several irreconcilable ways by the courts. It has been considered both as an implied term of the insurance policy,[2] and as a breach of section 17 of the Marine Insurance Act 1906,[3] for which the insurer's civil remedy was avoidance of the policy ab initio. It has also since been recognised as a distinct common law rule based on public policy,[4] where the insurer's remedy was forfeiture of the claim and permission to rescind the policy. Alternative positions have thus been created as to the remedies available to insurers in respect of fraudulent claims, but none long-established.

7.4 Kennedys LLP, a law firm, emphasised the importance of clarity in acting as an effective deterrent against fraud:

> For the law relating to fraudulent claims to be an effective deterrent, it should be clear and well understood, particularly as to what the consequences will be of any breach. Most opportunists do not appreciate that if they were to fraudulently exaggerate or fabricate part of a claim they risk receiving nothing at all.

[1] Insurance Contract Law, Issues Paper 7: The Insured's Post-Contract Duty of Good Faith (July 2010), paras 4.58 to 4.59.

[2] *Orakpo v Barclays Insurance Services Co Ltd* [1994] CLC 373. (ABI fn)

[3] *Black King Shipping Corporation v Massie (The Litsion Pride)* [1985] 1 Lloyds Rep 437. (ABI fn).

[4] Mance LJ in *The Aegeon (No 1)* [2002] EWCA Civ 247, [2003] QB 556. (ABI fn).

7.5 The Forum of Insurance Lawyers (FOIL) agreed: given the "moral ambivalence" of the public surrounding the serious problem of fraudulent insurance claims, statutory reform would provide a clear reminder of the duties owed by the insured.

7.6 Interestingly, the consultees who argued that the law was clear disagreed about what the legal position was. An academic commentator thought that the remedy was clearly forfeiture of the claim, stating that "the common law rule following especially [*The Aegeon*] is a clear and incontrovertible part of English law".[5]

7.7 By contrast, two respondents argued that the "clear" legal position included the right to avoid: the remedies of avoidance and forfeiture continued to exist alongside each other.

7.8 The responses we received have convinced us that there is a strong case for a new statutory provision setting out the remedies available to an insurer if a policyholder acts fraudulently.

FORFEITURE RATHER THAN AVOIDANCE

7.9 In Issues Paper 7, we proposed that an insured who makes a fraudulent claim should forfeit the whole claim to which the fraud relates. The fraud should not, however, invalidate previous, legitimate claims. The majority of consultees (17 of 21 who addressed the point) agreed.

7.10 The main argument against avoidance as a remedy for fraud is that it is unprincipled. It seems wrong that a valid claim made under a valid policy can be undermined by subsequent events. Roy Rodger, a broker, told us that this brings the industry into disrepute:

> There is no way the law should permit insurers to avoid a policy back to inception on the basis of a fraud that occurred several years after inception. That does not do our industry any credit.

7.11 As Royal & Sun Alliance put it:

> Any pre-existing valid claims should be dealt with on their merits, although these may be scrutinised again to ensure that they were honestly made.

7.12 We agree that insurers should be entitled to investigate previous claims, on the basis that they may have been fraudulent but had not been detected at the time. Valid claims, however, should not be recouped. As RBS Insurance put it:

> There should be no automatic retroactive penalty if there was no intention to commit fraud previously. However, we believe that insurers should have the right to review and re-investigate previously paid claims, where a subsequent one is found to be fraudulent.

[5] Johanna Hjalmarsson of Southampton University.

7.13 The second argument against avoidance is that it is impractical. The courts are reluctant to grant it. And even if the insurer won in court, a judgment may prove difficult to enforce, as the money is likely to have been spent.

7.14 Those who argued for avoidance acknowledged that it would be applied extremely rarely. Nevertheless, it was thought to be a useful tool in some circumstances. The ABI, for example, argued that insurers should still be permitted to have recourse to avoidance of the policy as a last resort. FOIL commented that "such a far reaching remedy will be inappropriate in the majority of cases but it should still be available in extreme circumstances".

7.15 It is possible that some insurers may still use avoidance as a threat against suspected fraudsters, even if the threat is usually a hollow one. The proposals we are making, however, strengthen the insurer's remedies for fraud, by clarifying the effect of fraud on subsequent claims and by providing a limited right of damages. Under this scheme, we think that the additional threat of avoidance is unnecessary.

7.16 As discussed in Part 8, we propose to end the remedy of avoidance under section 17. Avoidance of past claims is unprincipled and impractical, and appears unnecessarily harsh. Instead, valid past claims should be unaffected by a subsequent fraud. This reflects the approach already taken by the courts and by good market practice.

SUBSEQUENT CLAIMS

7.17 The courts have held that a fraudulent claim amounts to a repudiatory breach of the contract, giving the insurer the right to terminate the contract. After termination, no claims are payable. It is unclear, however, whether the insurer must pay claims arising between the date of the fraud and the date of the termination. As we saw in Part 6, some statements in the case law suggest that such claims should be paid, but there is no definitive ruling on the issue.[6]

7.18 In Issues Paper 7, we tentatively proposed that valid claims arising between the date of the fraud and the termination should be paid. We suggested that this was in line with normal contract principles, in which terminating a contract only brings a contract to an end after the termination.

7.19 Most insurers and practitioners disagreed, arguing that fraud should bring the contract to an end immediately. After consulting more widely on this issue, we have changed our approach. The argument against avoidance for previous claims is that it is unprincipled and impractical. These arguments were thought not to apply to subsequent claims.

7.20 First, as a matter of principle, it was felt that the insured's actions had undermined the contractual relationship, bringing the insurer's obligations to an end. Fraud undermined the necessary trust and good faith between the parties. Derrick Cole and Geoffrey Lloyd noted:

[6] See para 6.53 and following above.

> Having discovered fraud, it would be perfectly normal for the insurer to be extremely wary of subsequent claims for which they were still on risk. Trust would have evaporated.

7.21 Secondly, as a matter of practice, a rule which required the insurer to take action to terminate the contract would encourage premature allegations of fraud. Beachcroft, a law firm, put the point as follows:

> Fraud investigations can take considerable time and fraud is not an allegation to be made lightly. If termination is not to take place until the claim has been refused, insurers will feel that their hand is being forced to make knee jerk allegations of fraud in order to avoid more claims. This will not benefit either insurers or insureds.

7.22 The FOS agreed:

> In practice, the policy normally specifies that the termination dates from the fraud. It might be detrimental to consumers if the law encouraged insurers to exercise the right to terminate prematurely without fully investigating an allegedly fraudulent claim.

7.23 The denial of subsequent claims appears to be common market practice. Insurers frequently include express policy terms which specify that following a fraud, subsequent claims will not be covered. As we saw in Part 6, the courts are willing to uphold such terms.[7] Insurers may also reserve their rights upon being presented with a claim.

7.24 In Part 8 we propose that a fraudster should not only forfeit the claim to which the fraud relates but also all subsequent claims. We acknowledge that this is in line with current market practice.

7.25 An insurer would, however, still have a duty to act in a timely manner, either to reserve its rights or to terminate cover. As RBS noted, if an insurer was aware of a fraud and did nothing, this would constitute a waiver of the right to refuse subsequent claims.

DAMAGES FOR CLAIMS INVESTIGATION

7.26 As we saw in Part 6, the legal position appears to be that an insurer cannot claim damages for the reasonable and foreseeable costs of investigating a fraudulent claim. However, the possibility of damages for deceit remains.[8]

7.27 In Issues Paper 7 we asked an open question on this issue: did consultees think that an insurer should be entitled to claim damages for the reasonable and foreseeable costs of investigating a fraudulent claim?

[7] *Joseph Fielding Properties v Aviva Insurance* [2010] EWHC 2192, [2011] Lloyd's Rep IR 238.

[8] See para 6.58.

7.28 The present law provides a strong deterrent against exaggeration. The consequences of exaggeration may be severe. For example, in *Aviva v Brown*,[9] a consumer suffered subsidence, and had to move out of his home while the insurers carried out repairs. The consumer fraudulently claimed he was paying rent on the new property, whereas in fact he owned it. He not only forfeited the £58,500 in rent, but also the £177,000 for repairs.

7.29 By contrast, the civil law provides no deterrent against complete fabrication. If policyholders lie about the entire claim, they risk little actual loss. We thought that in the circumstances, there was a case for permitting the insurer to claim damages for the reasonable and foreseeable cost of investigating the fraud.

Support for damages claims

7.30 All but two respondents argued that insurers should be entitled to claim damages for investigation costs. It was thought that this would convey an effective anti- fraud message to potential fraudsters. Furthermore, the costs of investigating fraud can be substantial and insurers should be compensated for their actual losses. As Zurich noted:

> Insurers are incurring significant costs in creating ever more sophisticated business tools and processes to deter the professional fraudster. We believe that insurers should have the right to recover investigation costs. These costs would not have been incurred had it not been for the deceitful actions of the policyholder.

7.31 It was pointed out that in some cases, insurers succeed in claiming such costs. As Keoghs noted, however, a statutory remedy would be an improvement on the current practice of claiming under the tort of deceit:

> At present an insurer must bring a successful action in the tort of deceit to obtain this remedy which can be expensive and complex. Introducing a simple statutory remedy would act as a deterrent to fraudsters, thereby benefitting the insurance industry and society in general and honest policyholders in particular.

Concerns about damages claims

7.32 Some concerns were expressed about such claims. The FOS argued that damages claims were unfair, as the cost of investigating claims was an integral part of the insurer's business. The General Council of the Bar argued that such damages were impractical:

> We are of the view that in most cases insurers would find it difficult to recover such damages as in our experience, most fraudsters either do not have substantial means or have managed to conceal such assets as they have.

7.33 Furthermore, unlimited damages may impose an excessively onerous burden on insureds. Ray Hodgin of Birmingham University noted:

[9] [2011] EWHC 362 (QB).

The costs could get out of hand. I seem to remember long ago [an insurer] in one of its annual reports noting that the smallest appeal to it was for £5. If an insurer is prepared to go to such lengths then it is possible that a fraudulent claim for a small sum might escalate into a very large costs claim.

Limiting damages to "actual loss"

7.34 In Issues Paper 7, we suggested that damages should only cover net losses. Insurers should not be compensated for the costs of investigations where they had already recouped those costs through the savings accrued from not paying the legitimate element of the claim.[10] We thought that in a case such as *Aviva v Brown*,[11] where the insurer had already saved £177,000 in not paying a legitimate claim, it would be disproportionate also to require the consumer to pay large costs. This would effectively provide the insurer with double recovery.

7.35 The Faculty of Advocates supported our limitation, noting:

> To the extent that the costs of investigation were offset by the savings made, there is no recoverable loss.

7.36 Others felt that this would be an unnecessary complication. The ABI's views were repeated by several consultees:

> The ABI considers that prohibiting the insurer to recover costs from the fraudulent policyholder will only serve to weaken the deterrent to potential fraudsters.

7.37 In Part 8, we propose to introduce a statutory right for the insurer to claim damages for the reasonable, foreseeable costs of investigating a fraudulent claim in some circumstances. We do not wish to see this used, however, to impose excessive costs on those who have already suffered substantial losses through forfeiture of the legitimate elements of their claims. Damages would be limited to those cases where the insurer can show a net loss.

EXPRESS TERMS

Business insurance

7.38 As described in Part 6, many insurance contracts use express "fraud clauses" to extend the insurer's remedies for fraud. In commercial contracts, the courts are prepared to uphold such clauses, provided they are written in unambiguous terms. In the Issues Paper, we argued that freedom of contract should be preserved, and all but two consultees agreed.

[10] Insurance Contract Law, Issues Paper 7: The Insured's Post-Contract Duty of Good Faith (July 2010), paras 7.39 to 7.43.

[11] [2011] EWHC 362 (QB).

7.39 In Part 8, we propose new statutory provisions, setting out the remedies available to an insurer in the absence of a specific term. The question is whether, in dealing with businesses, an insurer should entitled to add to these remedies through an express term. In particular, should an insurer be entitled to specify that fraud will lead to the avoidance of the contract?

7.40 The argument for giving effect to such a clause is that the parties should be entitled to reach the agreement that best suits their needs. The argument against is that very few small to medium sized businesses are likely to understand the effect of "avoidance". Policyholders are unlikely to understand that the phrase "avoid the contract" means that the insurer can demand the repayment of a valid claim paid under a valid contract, which is wholly unconnected to the fraud. We have already described the remedy of avoidance as unprincipled and impractical. It is more likely to be used as a threat in negotiations rather than be a practical consequence of fraud.

7.41 As we discussed in Part 1 our starting point is to preserve freedom of contract.[12] In Part 8 we provisionally propose that an express fraud clause should be upheld, but only if it is written in clear unambiguous terms and specifically brought to the attention of the insured.

7.42 The converse issue is whether the parties should be entitled to use an express policy term to reduce the statutory remedies. In the Issues Paper we discussed how, under the current law, the parties to a contract may not exclude liability for fraud altogether. We concluded that this was right, and all 26 consultees who addressed this point agreed with us.

7.43 That said, there is a difference between excluding all liability for fraud and modifying some of the statutory remedies. The same arguments in favour of freedom of contract suggest that the parties should, if they wish, be entitled to reduce the remedies, even if they cannot exclude them all. For example, an express clause might state that fraud would only invalidate the claim to which the fraud relates, and not any subsequent claim. Again, to be valid, we think that any such clause would need to be written in clear, unambiguous terms and be brought to the attention of the other party. For example, if the insured's broker put such a clause forward, it would need to be brought specifically to the attention of the insurer.

Consumer insurance

7.44 In consumer contracts, there is a case for a different approach. We think that the statutory rules we have outlined provide clear, effective deterrents against fraud in consumer insurance. If a term were to permit avoidance from the start of the contract, consumers would be very unlikely to understand the implications of this. As the General Council of the Bar put it:

> We doubt that most consumers read insurance terms and their policies will invariably be on insurers' standard terms.

[12] See paras 1.41 and 5.15 and following.

7.45 The Unfair Terms in Consumer Contracts Regulations 1999, together with the FOS jurisdiction, already provide some protection. The 1999 Regulations, however, do not provide easy answers. A consumer who wishes to challenge a clause permitting avoidance for fraud would face a difficult task, with an uncertain outcome.

7.46 In Part 5, we argued that any term which excluded the insurer's liability for late payment should be of no effect. We think that a similar provision should be included in this context.[13]

Excluding the fraud of agents

7.47 As noted in Part 6,[14] there is uncertainty in common law as to whether parties may contractually exclude liability for the fraud of their agents. The point was considered by the House of Lords in *HIH Casualty & General Insurance v Chase Manhattan Bank.*[15] Lord Bingham noted that for such an express term to be valid, it would have to employ language which would:

> alert the commercial party to the extraordinary bargain he is invited to make.[16]

7.48 In this case, the term was too ambiguous to exclude fraud by the agent. The court did not decide on whether it would ever be possible for contracting parties to exclude liability for their own agents' fraud, if the language was sufficiently clear.

7.49 In Issues Paper 7, we sought views on the issue: Sixteen of 23 consultees agreed that parties should be entitled to exclude liability for the fraud of their agents if they wished, but many qualified their support.

7.50 Several consultees noted that the issue would very rarely arise in practice, as only the most powerful of policyholders would ever be in a position to demand such a clause. BILA did not consider the issue to be important in practice, describing the point as "commercially insignificant". The Lloyd's Market Association noted:

> In practice we believe it is highly unlikely that an insurer would agree to take this risk in relation to the insured's broker or sub-broker.

7.51 Our consultation revealed no demonstrable need to legislate in this area. Given that such clauses are so rare, the courts would seem to be best placed to resolve any issues. The present position would appear to be that such an exclusion clause may represent a genuinely negotiated bargain, in which case it would be upheld. Any clause excluding liability for an agent's fraud, however, would need to be written in a very clear way. We think this is right, and make no proposals on the issue.

[13] See paras 5.20 and following.

[14] See para 6.24.

[15] [2003] UKHL 6, [2003] 1 All ER (Comm) 349, [2003] 1 CLC 358.

[16] Above, at [16].

THE FUTURE OF SECTION 17

7.52 The changes we are proposing raise questions about the future of section 17 of the Marine Insurance Act 1906, which states that a contract of insurance is "based upon the utmost good faith". In Issues Paper 7 we asked whether the post-contract duty of good faith applied in other contexts, outside the area of fraudulent claims. We concluded that the duty had limited application. For example, we thought that issues of notification of risk are best handled through express terms rather than as a matter of good faith. Most consultees agreed that the insured should only have a duty to report increases in the risk if the contract included an express term to that effect. Furthermore, any such express term should be interpreted restrictively.[17]

7.53 As we discussed in Part 5, we think that the duty of good faith is best seen as a shield rather than a sword. It is a general interpretative principle, and it may be used to prevent a party from relying on a contractual provision to justify actions taken in bad faith. It becomes problematic, however, when it is used as a cause of action in its own right, especially as it only specifies one remedy, namely avoidance.

7.54 In our next consultation paper, on the pre-contract duty of disclosure in business insurance, we will return to the issue of whether avoidance is always the appropriate remedy for non-disclosure or misrepresentation. At the same time, we will make proposals to reform section 17. Our current thinking is that the duty of good faith should remain as a general principle, but that it should not, in itself, provide any specific remedies. Instead the appropriate remedies for late payment, fraudulent claims, non-disclosure and misrepresentation should be specifically set out in legislation.

CONCLUSION

7.55 There is strong support for statutory reform to clarify the remedies for fraudulent claims. Our proposed reforms are designed to strengthen the sanctions against fraud, but to do so in a principled and balanced way.

7.56 At present, avoidance is used as a threat rather than a remedy. The courts are extremely reluctant to allow a fraudulent claim to affect a previous, valid claim. The proposed reforms would uphold the existing case law by clarifying that avoidance is not the appropriate remedy for want of good faith during the currency of the contract.

7.57 At the same time, the proposed reforms would provide the insurer with firm, practical remedies. First, we intend to clarify that fraud forfeits subsequent claims, even legitimate ones, where the loss arises after the fraud. Secondly, insurers will be entitled to recover reasonable costs of investigating frauds, where these losses are not recouped in other ways. This will provide a penalty in major frauds, where the whole claim is fabricated.

[17] See Issues Paper 7: Summary of Responses, part 6 http://www.justice.gov.uk/lawcommission/consultations/insureds-postcontract-duty-of- good-faith.htm

PART 8
INSURERS' REMEDIES FOR FRAUD: PROPOSALS FOR REFORM

8.1 Fraud is a serious and expensive problem, and it is important that the law sets out clear sanctions. Yet, the law on the consequences of a fraudulent claim is convoluted and confused, and has generated many conflicting cases. The great majority of respondents to our Issues Paper supported statutory reform.

8.2 As discussed in Issues Paper 7, we leave the definition of fraud to the common law. Our proposals deal only with the remedies. We propose that a policyholder who makes a fraudulent claim should forfeit the whole claim to which the fraud relates. The fraudster should also forfeit any subsequent claim which arises after the date of the fraud. Fraud should not however affect any previous valid claims, whether or not the insurer has made a payment.

8.3 We propose that insurers should also be entitled to damages for the reasonable costs actually incurred in investigating the fraudulent claim, where the insurer would otherwise suffer loss as a result of the fraud. In other words, damages would be available where the insurer has not been compensated for the investigation costs by the savings from not paying the legitimate element of a forfeited claim.

8.4 In business insurance, these provisions form a default position which could be varied or departed from by agreement of the parties. In consumer insurance, an insurer would not be entitled to add to these remedies through a contract term.

A STATUTORY CODE

8.5 We provisionally propose a new statutory provision setting out the remedies for a fraudulent claim. Section 17 of the Marine Insurance Act 1906 would no longer apply to fraudulent claims.

8.6 Our proposals are in four parts:

(1) A policyholder who commits a fraud in relation to a claim forfeits the whole claim to which the fraud relates. Any interim payments made in respect of the claim must be repaid.

(2) The policyholder also forfeits any claim which arises after the date of the fraud.

(3) The fraud does not affect any previous valid claim where the loss arises before the fraud takes place, whether or not the claim has been paid.

(4) The insurer has a right to claim the costs reasonably and actually incurred in investigating the claim, provided that the insurer has not already received recompense for these costs through the first and second remedies.

FORFEITURE OF THE WHOLE CLAIM

8.7 The remedy of forfeiture is clearly established in case law.[1] The cases establish that any fraudulent exaggeration which is "not insubstantial" leads to the loss of the legitimate element of the claim.[2] The insurer may recoup any interim payments already made. An example is *Galloway v Guardian Royal Exchange (UK) Ltd*.[3] Mr Galloway was burgled and suffered a genuine loss of around £16,000. When he submitted his claim, however, he fabricated a claim for a fictitious computer for around £2,000. The Court of Appeal rejected the whole claim, including the £16,000 of genuine loss.

8.8 We intend to give statutory effect to the common law remedy of forfeiture, as established in the existing cases. This means that if a policyholder commits a fraud in relation to a claim, the whole claim is forfeited.

8.9 The fraudulent element and the genuine element of the claim do not need to be submitted at the same time, if both are held to be part of a single claim. The courts have tended to give a wide meaning to the concept of single claim, especially where different elements arise from the same incident. For example, in *Yeganeh v Zurich Insurance*,[4] a policyholder who was fraudulent in his contents claim was held to have lost any right to recover for damage to the premises in which the contents were housed. In *Aviva Insurance v Brown*,[5] the policyholder claimed for subsidence to his home, which led him to seek alternative accommodation. He claimed rent for alternative accommodation without revealing he owned the property concerned. This was held to be fraudulent. The claims for the cost of the subsidence and for the alternative accommodation were held to be the same claim, as both arose from the same incident. Both the accommodation and the repair elements of the claim were forfeited.[6]

8.10 Our view is that the meaning of the concept of a single claim (and how wide that interpretation should be) is best left to the courts to develop, based on the facts and circumstances of each case.

[1] *Galloway v Guardian Royal Exchange* [1999] Lloyd's Rep IR 209; *Agapitos v Agnew (No 1) (The Aegeon)* [2002] EWCA Civ 247, [2003] QB 556; *Axa General Insurance Ltd v Gottlieb* [2005] EWCA Civ 112, [2005] 1 All ER (Comm) 445. In Scotland, see discussion in *Fargnoli v GA Bonus Plc* 1997 SCLR 12, [1997] CLC 653, [1997] 6 Re LR 374.

[2] For further discussion of the meaning of "not insubstantial" see Insurance Contract Law, Issues Paper 7: The Insured's Post-Contract Duty of Good Faith (July 2010), paras 3.4 to 3.29.

[3] [1999] Lloyd's Rep IR 209.

[4] [2010] EWHC 1185, [2011] Lloyd's Rep IR 75. Subsequently overturned by the Court of Appeal ([2011] EWCA Civ 398) on unrelated grounds – we are grateful to Professor Merkin for raising this issue.

[5] [2011] EWHC 362 (QB).

[6] Above at [122].

FORFEITURE OF SUBSEQUENT CLAIMS

8.11 The effect of a fraud on subsequent claims is uncertain. It is clearly established that fraud gives the insurer the right to terminate a contract with prospective effect. There is some doubt, however, about the status of claims which arise between the time of the fraud and the time of termination.

8.12 We have been persuaded by the arguments put to us that subsequent claims should also be forfeited, even if the claim arises before the insurer discovers the fraud or has taken steps to terminate the contract. It was thought to be more practical than the alternative, which would encourage insurers to rush to terminate the contract on the slightest suspicion of fraud. As we explain in the examples set out below, a fraud would effectively discharge the insurer from liability for any loss which takes place after the date of the fraudulent act, whether or not the fraud has been discovered.

8.13 That said, on discovery of a fraud, the insurer is expected to take some action to communicate the finding to the insured and terminate the cover. If an insurer has evidence of fraud and takes no action, it will be taken to have waived its defence to a subsequent claim.

NO AVOIDANCE OF PREVIOUS VALID CLAIM

8.14 In Part 6, we discussed the remedy of avoidance as set out in section 17 of the Marine Insurance 1906. Despite the clear words of the statute, the courts have been reluctant to allow insurers to recoup valid claims already paid under the contract. As Lord Penrose stated in *Fargnoli v GA Bonus Plc,* the penalty of a fraudulent claim should "not extend beyond the offence to deprive persons of innocent benefits, or benefits otherwise free from the taint of fraud".[7]

8.15 As discussed in Part 7, avoidance was thought to be unprincipled and of little practical value. We were told that very few insurers attempt to invalidate previous legitimate claims. The majority of respondents to Issues Paper 7 agreed that a fraudulent claim should not affect previous claims, whether or not they have been paid. This included several leading insurers.

EXAMPLES

8.16 The following examples illustrate the application of these proposals. Suppose that an insured has taken out a buildings policy, and, over the term of the policy, the following events take place.

Example 1: second claim is fraudulent

January: A fire occurs on the insured's premises, which destroys 100 computers on the site. The insured makes a legitimate claim for the loss.

March: Whilst the first claim is being considered, a flood occurs, which destroys a further 50 computers. The insured makes a fraudulently exaggerated claim for 75 computers.

[7] 1997 SCLR 12, at p 39.

In this case, the whole of the March claim is forfeited, but the insurer must pay the January claim, which is unaffected by the subsequent fraud.

Example 2: first claim is fraudulent

> January: The fire destroys 100 computers on the site. February: The insured claims for the fire, submitting a fraudulently exaggerated claim for 125 computers.
>
> March: Whilst the first claim is being considered, a flood destroys a further 50 computers. The insured makes a legitimate claim.
>
> April: The insurer discovers the February fraud, and writes to terminate the contract.

Here, under our proposals, the insurer is not liable to pay either claim. The January claim is forfeited as a result of the fraudulent exaggeration. The fraud also effectively ends the insurer's liability under the contract, from the date the fraudulent claim is submitted, in February.

Example 3: fraud committed after second loss

> January: The fire destroys 100 computers on the site. The insured initially submits a genuine claim.
>
> March: A flood destroys a further 50 computers.
>
> April: The insured submits a fraudulent claim in respect of the January fire, claiming for 25 additional computers.
>
> May: The insured makes a legitimate claim for the March flood.

Here the insurer is not liable to pay the January claim: the whole claim is forfeited as result of the April fraud. However, the insurer is still required to pay the legitimate claim for the March flood, as the loss took place before the fraudulent act. It is as if the insurance was automatically brought to an end in April. If this has happened, the insurer would remain liable to pay the March losses. In practice, of course, the insurer is likely to scrutinise the May claim very carefully.

8.17 **Do consultees agree that a policyholder who commits a fraud should: (1) forfeit the whole claim to which the fraud relates?**

(2) also forfeit any claim where the loss arises after the date of the fraud?

(3) be entitled to be paid for any previous valid claim which arose before the fraud took place?

.18 **Do consultees agree that the definition of "the whole claim" should be left to the courts?**

DAMAGES FOR ACTUAL LOSS

.19 Under the current law, damages are not available for post-contract breaches of good faith by the insured.[8] In *London Assurance v Clare,*[9] this was held to mean that damages in respect of the cost of investigating a fraudulent claim were not available. It is possible that the insurer may be able to claim damages for deceit.

.20 We think that damages should be available to cover the reasonable costs of investigating a claim in limited circumstances. Insurers can incur substantial costs in investigating increasingly sophisticated fraud. To make damages available in some cases would provide a deterrent to claims which are entirely fabricated, and the remedy of forfeiture has little practical effect. That said, damages are intended to compensate insurers for actual loss. Insurers should not be entitled to "double recovery", where the savings made from the forfeited claim already offset the costs of investigation.

.21 The following examples illustrate our proposal:

Example 1

> An insured suffers a genuine loss of £1,000 and uses a fraudulent device to claim a further £100. When the fraud is discovered, the insured forfeits the entire claim for £1,100.
>
> The insurer has spent £500 investigating the claim. It is not entitled to any damages for claims investigation, as it has effectively "saved" £1,000 in not having to pay out in respect of the genuine loss.

Example 2

> An insured suffers a genuine loss of £5,000 and uses a fraudulent device to claim a further £5,000. When the fraud is discovered, the insured forfeits the entire claim for £10,000.
>
> The insurer has spent £6,000 investigating the claim. Provided that these costs are reasonable, and reasonably incurred in the circumstances, it is entitled to the costs of investigation, minus the monies recouped from not paying the legitimate element of the claim. Therefore, the insurer is entitled to £1,000 in damages.

[8] *La Banque Financier de la Cite v Westgate Insurance Co* [1987] 2 WLR 1300.

[9] (1937) 57 LI L Rep 254 by Goddard J at p 270.

Example 3

> An insured makes a wholly fraudulent claim of £10,000. The insurer has spent £1,000 investigating the claim. It is entitled to the whole of the costs.

What must the insurer prove?

8.22 To establish a damages claim, the insurer would need to prove all the elements of the claim. It would therefore need to show that:

(1) The policyholder committed a fraud; and

(2) the insurer actually incurred costs in investigating the fraud. The insurer will need to prove each expense. It would not be entitled to a standard cost or to a proportion of the costs of running the claims department, such as office overheads; and

(3) the costs were reasonable and proportionate in the circumstances; and

(4) the costs were not offset by any saving from legitimate, forfeited claims.

8.23 **Do consultees agree that the costs of investigating proven fraud should be recoverable if the insurer can show that the costs were:**

(1) actually incurred?

(2) reasonable and proportionate in the circumstances?

(3) not offset by any saving from legitimate, forfeited claims?

EXPRESS TERMS

Business insurance

8.24 Many insurance contracts use express "fraud clauses" to extend the insurer's remedies for fraud. In business contracts, the courts are prepared to uphold such clauses, provided they are written in unambiguous terms.

8.25 We provisionally propose that an express fraud clause should be upheld, but only if it is written in clear unambiguous terms and specifically brought to the attention of the other party. Thus it would be open to an insurer to extend the remedy for fraud, for example to include avoidance of the contract. The clause would, however, need to be clearly written and highlighted in the pre-contract documents.

8.26 An insurer may also agree to reduce the sanctions against fraud, provided that the contract does not exclude liability completely. Again, the clause would need to be clear and unambiguous. If it were put forward on the insured's behalf, it would need to be drawn to the insurer's attention.

8.27 **Do consultees agree that in business insurance:**

(1) the remedies for fraud should be subject to an express term of the contract?

(2) a clause which changes the statutory remedies should be written in clear, unambiguous terms and specifically brought to the attention of the other party?

Consumer insurance

8.28 In consumer contracts, we think that the statutory remedies should not be extended by contract. Consumers are unlikely to understand the implications of "avoidance", or be able to exercise any bargaining pressure. The Unfair Terms in Consumer Contracts Regulations 1999, together with the FOS jurisdiction, already provide some protection. A consumer who wishes to challenge a clause permitting avoidance for fraud would, however, face a difficult task, with an uncertain outcome.

8.29 We propose that in consumer insurance, any term which purports to give the insurer greater rights in relation to fraudulent claims than those set out in statute would be of no effect.

8.30 **Do consultees agree that in consumer insurance, any term which purports to give the insurer greater rights in relation to fraudulent claims than those set out in statute would be of no effect?**

PART 9
INSURERS' REMEDIES FOR FRAUD: CO-INSURANCE AND GROUP INSURANCE

9.1 In this Part we consider the specific issues which arise when a fraudulent claim is submitted by a co-insured, or by a member of a group scheme.

CO-INSURANCE

9.2 Difficult questions arise where two or more policyholders are insured under the same policy, and one policyholder commits fraud or deliberate destructive acts. How far does fraud by one party affect the other party's rights? Where two or more people take out insurance jointly to protect their property, the law usually treats them as acting together. As a result, fraud by one party will result in forfeiture of the other party's share of the claim. This can lead to harsh results where the parties have become estranged.

A summary of the current law

9.3 If the fraudster is found to have made the claim on behalf of the other policyholder, the fraudster will be treated as an agent whose fraud is attributed to the principal "innocent" policyholder.[1] If the fraudster did not act as an agent, then the court must decide whether the insurance policy was a "joint" policy or a "composite" policy.

9.4 The distinction between joint and composite policies does not necessarily depend on the policy wording[2] and can be uncertain. If both parties own the property jointly[3] and have a single interest, then the policy is usually considered to be a joint one. If the co-insureds have different interests or rights to the property, then the policy will be considered composite.

9.5 Under a composite policy, the obligations are said to be "several" and thus misconduct by one policyholder will not affect the claim of the others.[4] Mr Justice Rix has explained that a composite policy can be understood as a "bundle of separate contracts".[5]

[1] This was illustrated by *Black King Shipping Corporation and Wayan (Panama) SA v Mark Ranald Massie ("The Litsion Pride")* [1985] 1 Lloyd's Rep 437; and in *Direct Line Insurance Plc v Khan* [2001] EWCA Civ 1794, [2002] Lloyd's Rep IR 364.

[2] Co-insureds with a joint insurable interest can obtain composite cover, and vice versa. It is implicit in the decision of the Court of Appeal in *Direct Line Insurance Plc v Khan* [2001] EWCA Civ 1794, [2002] Lloyd's Rep IR 364 that joint tenants could insure compositely if they wanted to.

[3] The equivalent term in Scots law is common property; joint property refers only to property held by trustees or unincorporated associations. See KGC Reid *The Law of Property in Scotland* (1996), para 34.

[4] *P Samuel & Co Ltd v Dumas* [1924] AC 431; *New Hampshire Ins Co v MGN Ltd* [1997] LRLR 24.

[5] *Arab Bank Plc v Zurich Insurance Co* [1999] 1 Lloyd's Rep 262, at p 277.

9.6 The opposite is true under a joint policy. As Viscount Cave has explained, where two policyholders are jointly insured, "the misconduct of one is sufficient to contaminate the whole insurance".[6]

9.7 A possible scenario where this might lead to injustice is where a husband and wife take out joint insurance on their joint property, and one commits an act as deliberate retribution against the other, such as burning down the matrimonial home. This scenario has arisen in other jurisdictions,[7] but has not been faced by the English and Scottish courts. Other common law jurisdictions have been sympathetic to an innocent co-insured who has suffered from the wrongful act of a co-insured, and have found ways to allow the innocent party to recover his or her share of the loss.[8]

9.8 In Issues Paper 7, we thought that it was right to protect innocent joint policyholders in these circumstances. We tentatively proposed legislation to protect a joint policyholder who could prove that a fraud or wrongful act was carried out without his or her knowledge.

Consultees' views

9.9 Most consultees supported our proposal in principle, but many queried how it would operate in practice. There were two elements: a rebuttable presumption that fraud is committed on behalf of all parties; and a requirement that recovery is limited to the innocent insured's interest. We look at each element below.

A rebuttable presumption that fraud is committed on behalf of all parties

9.10 We suggested that in joint insurance there should be a presumption that any fraud committed by one party is done on behalf of all parties. It should be open to an innocent party, however, to rebut this presumption. Innocent parties who produce evidence that the fraud was not carried out on their behalf or with their knowledge, should be paid their share of the claim.

9.11 The proposal was popular, with 16 of 21 consultees supporting the idea in principle. It was felt to strike a more balanced approach between the parties (often conflicting) interests under a joint policy, and protect those who were clearly innocent of wrongdoing. Several consultees, however, queried whether the idea was workable. They asked how a policyholder could prove a negative, namely non-involvement in a fraud.

Limiting recovery to the innocent insured's interest

9.12 We also suggested that recovery should be limited to the innocent insured's own interest, and that the claim should be payable only where the guilty insured would not benefit.

6 *P Samuel & Co Ltd v Dumas* [1924] AC 431, at p 445.

7 In the US, see *Klemens v Badger Mutual Insurance Co of Milwaukee* (1959) 8 Wis 2d 565, 99 NW 2d 865. In Australia, see *Holmes v GRE Insurance Ltd* [1988] TASSc 14; (1988) Tas R 147. In New Zealand, see *Maulder v National Insurance Company of New Zealand Ltd* [1993] 2 NZLR 351.

8 For discussion, see Insurance Contract Law Issues Paper 7: The Insured's Post-Contract Duty of Good Faith (July 2010), Part 5.

9.13 Most consultees (15 of 21) agreed, but many expressed concern about the practical operation of the proposal. Consultees worried that where the parties were married, it would be difficult for an insurer to value the innocent policyholder's share. As Royal & Sun Alliance (RSA) pointed out, "where the property is jointly owned, even the divorce courts have difficulty in separating interests". They asked:

> What is [the innocent party's] share? 50%? Should this take account of the length of time the couple have been married? Or the assets that they brought into the relationship? Income? Children and their age? What one party has put into a relationship? 50% is just a figure and means nothing in terms of legal entitlement.

9.14 RSA also thought it would be difficult to prevent the guilty party from benefitting, particularly where couples separate and then reconcile. Additionally, for home insurance, consultees queried how an insurer might be expected to reinstate half a house. The ABI summarised these concerns as follows:

> We are concerned that in many circumstances, the guilty party will benefit from his own fraud, for instance where the joint policyholders continue to cohabit or where they live apart for a while and subsequently reconcile. How is the insurer expected to quantify the rateable proportion of an indemnity, and to rebuild half of a jointly owned property burnt to the ground by the jealous husband without benefitting him, for example?

9.15 Several consultees suggested that there may be unintended consequences to the proposal. For example, the International Group of P&I Clubs queried whether the case had been made for reform in commercial policies, for which insurers ought to retain the freedom to incorporate express terms and conditions.

9.16 Yet, despite these difficulties, many consultees expressed support for the proposal. They felt that the complexities of valuing an innocent party's share was not a reason for denying the innocent party's claim altogether.

Conclusion

9.17 The typical problem with which we are concerned is where a husband and wife take out joint insurance on the matrimonial home, and one spouse acts unilaterally in burning it down. There is a clear case to protect the innocent spouse by allowing the innocent party to claim his or her share of the loss. This problem has arisen in several common law jurisdictions, and the courts have generally found a way to do justice in the individual case.

9.18 The question is whether this issue requires a legislative solution. Any legislation will need to deal with complex issues of proof and valuation, and may prove a blunt way of dealing with the sensitivities involved. We would not wish to legislate in the absence of a demonstrable need.

9.19 We have not found evidence that fraudulent claims in co-insurance are a problem in practice. Although cases have been decided in other jurisdictions, the scenario has yet to arise before the English or Scottish courts. We have only found one such case in the Financial Ombudsman Service records. We suspect that many insurers already pay the innocent party's claim without relying on their strict legal rights. And if the issue were to be taken to court, we think that the courts could find a fair solution, by applying the reasoning used by other Commonwealth courts.

9.20 Our current view on the basis that there appears to be no evidence of a significant issue, is that legislative intervention is not necessary. If however, there is significant evidence to the contrary we may reconsider the position. We invite consultees to tell us about any problems they have experienced with the law of fraudulent claims in joint insurance. In the absence of such evidence, we do not currently propose legislative reform on this issue.

9.21 **Do consultees have evidence that the law of fraudulent claims by joint insureds causes problems in practice? If so, we would be grateful if consultees could provide us with such evidence or examples, and also provide us with information on how these issues were dealt with (either by the firm concerned or by any other body).**

9.22 **Do consultees agree that there is no need to legislate on the effect of fraud by one joint insured on the other joint insured's claim?**

GROUP INSURANCE

9.23 Group insurance is a common way to provide life insurance and other long-term benefits. Typically an employer or other policyholder takes out insurance for the benefit of employees or other members of a definable group. The individual members are not however party to the policy of insurance. Payments are often discretionary and individual members do not have any enforceable right to them.[9]
Swiss Re has estimated that group schemes provide over 60% of long-term income protection benefits and nearly 40% of life cover.[10] Yet the law is underdeveloped.

[9] See *Green v Russell* [1959] 2 QB 226. Insurers also exclude the possibility of members gaining rights under the Contracts (Rights of Third Parties) Act 1999. In Scots law, members might acquire a *jus quaesitum tertio* (a right acquired by a third party in a contract between others) but only if there was an intention to benefit them. See, for example, *Love v Amalgamated Society of Lithographic Printers* 1912 SC 1078.

[10] Figures provided by Swiss Re for the Consumer Insurance Law Project.

9.24 As group members are not parties to the insurance contract, the normal obligations that apply to policyholders do not apply to them. In our 2009 Report, *Consumer Insurance: Pre-Contract Disclosure and Misrepresentation*, we noted that group members are not subject to the obligations on policyholders to give pre-contract information. Thus the Consumer Insurance (Disclosure and Representations) Bill makes special provision for group schemes. The Bill ensures that the duty on policyholders to answer questions honestly and carefully also applies to group members. Furthermore, the Bill clarifies that if a misrepresentation is made by a group member, it has consequences only for that individual. This Bill was introduced into the House of Lords on 16 May 2011.[11]

9.25 The same issue arises in connection with fraudulent claims. As group members are not policyholders, they do not appear to be subject to the sanctions that apply to policyholders who make fraudulent claims. Thus if a group member fraudulently exaggerates a loss, the normal rules of forfeiture do not apply. As we understand the law, the only penalty is that the member would not receive the fraudulent element of the claim.

Consultees' views

9.26 In Issues Paper 7, we asked whether legislation on fraudulent claims should make special provision for group schemes, along the lines of the provisions in the Consumer Insurance (Disclosure and Representations) Bill. The effect of our proposal would be that a group member who acts fraudulently to obtain a benefit under the group scheme would forfeit the whole benefit, and any subsequent benefit, and would be liable to pay the insurer's reasonable costs of investigating the fraud.

9.27 Most consultees agreed that special statutory provisions were needed. As the General Council of the Bar noted:

> At present, whilst a group member's fraudulent claim would not succeed to the extent that it was fraudulent ... the common law arguably does not go further and allow the court to penalise the fraudulent group member – for example by requiring the genuine parts of the claim also to be forfeited.

9.28 Legislation would provide clarity and consistency, and establish beyond doubt that the group member is in the same position as the direct policyholder. Moreover, it would ensure consistency with the pre-contract position. The ABI pointed out:

> It makes sense, for consistency with the position pre-contract, that any new legislation regarding the law post-contract directly addresses the fraudulent claims by insured members.

[11] See Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation (2010) Law Com Report No 319; Scot Law Com No 219, paras 7.10 to 7.19.

Proposal for reform

9.29 We provisionally propose that any statutory reform of the law of fraudulent claims should include special provision to deal with fraud by members of a group scheme. Where a group member acts fraudulently to obtain a benefit under the scheme, the same rules should apply as if a policyholder had made a fraudulent claim. In other words, the member would forfeit the whole benefit, and any subsequent benefit, and would be liable to pay the insurer's reasonable investigation costs. However, the fraud by one or more group members would have no effect on benefits to other members.

9.30 **Do consultees agree that a fraudulent act by one or more group members should be treated as if the group member concerned was a party to the contract?**