

### 3 Stone Buildings

## Insurance and Reinsurance Seminar: Wednesday 12<sup>th</sup> October 2005

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#### Avoidance: Have the rules changed?

#### Introduction

1. The appropriateness of an insurer avoiding for non-disclosure has been a subject of debate since Lord Mansfield's classic judgment in Carter v. Boehm in 1766.
2. Likewise, the basis on which an insurer can and should be permitted to avoid a policy for non-disclosure has been discussed since not long afterwards. This evening's seminar is just one more step along these tortuous paths.
3. I am not, however, going to bore you with the entire history. But I want particularly to examine whether there has been a perceptible or imperceptible change in the rules since the House of Lords' landmark decision in 1995 in Pan Atlantic Insurance Co v. Pine Top Insurance Co [1995] AC 501. As we all know, that case apparently settled the rules once and for all, but it has not quite settled the debate.
4. My conclusion is that the rules have not changed, but that the wave of unorthodox Court of Appeal decisions are in the ascendancy. They may be no more than examples of the maxim "hard cases make bad law". But I will explore briefly the questions of:-
  - (1) Whether there ought to be a change in the law?
  - (2) What that change ought to be?

#### Background

5. The starting point for avoidance and the doctrine of good faith in English Law is Carter v Boehm (1766) 3 Burr 1905.
  - (1) Mr Carter was the Governor of Fort Marlborough on the island of Sumatra. He took out a policy of insurance with Mr Boehm, against the fort being taken by a foreign enemy. It was

established by the evidence of one Captain Tryon that Governor Carter knew, but did not disclose, (i) that the fort was designed to resist the natives, rather than European enemies and (ii) that the French were likely to attack, which they did.

- (2) In relation to Mr Carter's claim under the policy, Lord Mansfield said at page 1909:

*“The special facts, upon which the contingent chance is to be computed, lie most commonly in the knowledge of the insured only: the under-writer trusts to his representation, and proceeds upon confidence that he does not keep back any circumstance in his knowledge, to mislead the under-writer into a belief that the circumstance does not exist, and to induce him to estimate the risque, as if it did not exist. The keeping back such circumstance 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”.*

- (3) Lord Mansfield regarded this principle as applicable to all contracts. But English law did not develop in this way. It is only in relation to certain types of contract, insurance in particular, that a party is entitled to avoid a contract on the basis of “non-disclosure”.

6. In the Law of Insurance Contracts, Malcolm Clarke summarises the “rules” governing Non-Disclosure at 23-1C as follows:-

*“To rescind the contract of insurance or raise the defence of non-disclosure the onus is on the insurer to prove non-disclosure of material fact which is known to the proposer, which would influence the judgement of a prudent insurer and which, if disclosed, would have induced the actual insurer not to make the contract or to make it on different terms.”*

7. This breaks down into the two classic tests of:-

- (1) Materiality: the objective test of whether the insured failed to disclose a material fact that would have influenced the judgment of a prudent insurer; and
- (2) Inducement: The subjective test of whether, if disclosed, the fact would have induced the insurer either not to write the business or to write it on different terms.

8. These rules are based on the judgments of the House of Lords in Pan

Atlantic Insurance Co v Pine Top Insurance Co [1995] AC 501.

- (1) The defendant reinsurers had written excess of loss policies for three years. Their defence to a claim in respect of losses suffered in the third year was based on an inadvertent failure to disclose the true extent of the losses suffered in the first two years.
- (2) In the CA, Nicholls V-C expressed his discomfort at holding that the reinsurers were entitled to avoid all liability where it was accepted that, if the losses had been disclosed, the result would only have been an increased premium.
- (3) Nevertheless, the CA did uphold the trial judge's conclusion that the reinsurers were entitled to succeed. In the course of arriving at this decision, however, Steyn LJ held that the test of materiality was "*whether the prudent insurer would view the undisclosed material as probably tending to increase the risk*" (see the quotation in Lord Mustill's speech at p. 527).
- (4) The House of Lords upheld the result arrived at by the CA, but disagreed about the test for materiality. Lord Mustill said that disclosure was not limited to matter which would have caused the prudent underwriter to decline the risk or charge an increased premium (in this, he was in a majority of 3:2). He thought that a matter was material "*even though a full and accurate disclosure of it would not in itself have had a decisive effect on the prudent underwriter's decision whether to accept the risk and if so at what premium*" (page 550C). In other words, there was a duty to disclose "*all matters which would have been taken into account by the underwriter when assessing the risk ... which he was consenting to assume*" (page 538 D).
- (5) At the same time, however, Lord Mustill held that "*if the misrepresentation or non-disclosure of a material fact did not in fact induce the making of the contract (in the sense in which that expression is used in the general law of misrepresentation) the underwriter is not entitled to rely on it as a ground for avoiding the contract*" (page 550 D).
- (6) The end result is that an insurer has to prove that he would not have underwritten the risk, or at least would only have done so on different terms, before he is entitled to avoid the policy.
- (7) This did not assist the appellants, however, since the House of Lords held that the facts which were not disclosed were so obviously material that inducement could be inferred (or,

perhaps, on one interpretation of Lord Mustill's speech, there is a presumption of inducement).

#### Matters to bear in mind

9. In looking at recent decisions, one must bear in mind the parameters by which they are to be judged:-
  - (1) A distinction is to be drawn between commercial and consumer insurance, because of the inapplicability of the deemed knowledge provisions in section 18 of the Marine Insurance Act 1906 to private individuals:-
    - (a) Economides v. Commercial Union Assurance Co. [1998] Q.B.587 at 607.
    - (b) Group Josi Re v. Walbrook Insurance Co. Ltd. [1996] 1 W.L.R. 1152, 1168-1169.
    - (c) Drake Insurance v. Provident Insurance *infra*.
  - (2) Only Parliament or the House of Lords can actually change the decision in Pan Atlantic.
  - (3) There are some peripheral areas in which the law has developed recently, but I am concerned this evening primarily with the core rules.

#### Recent cases

10. In Kauser v Eagle Star [2000] Lloyd's Rep IR 154 at 157, Staughton LJ observed as follows:-

*“Avoidance for non-disclosure is a drastic remedy. It enables the insurer to disclaim liability after, and not before, he has discovered that the risk turns out to be a bad one; it leaves the insured without the protection which he thought he had contracted and paid for. Of course there are occasions where a dishonest insured meets his just deserts if his insurance is avoided; and the insurer is justly relieved of liability. I do not say that non-disclosure operates only in cases of dishonesty. But I do consider that there should be some restraint in the operation of the doctrine. Avoidance for honest non-disclosure should be confined to plain cases”.*

11. Drawing on this point of view, Coleman J in The Grecia Express [2002] 2 Lloyd's Rep 88 held that, where allegations have been made about an individual which he or she can prove to be false, the policy cannot be avoided for failure to disclose the allegations. In particular, Colman J considered that an avoidance in such circumstances would be contrary to the insurer's duty of good faith and suggested that this would be "*so unconscionable as to disentitle the insurers from invoking the equitable jurisdiction of the court to avoid the contract on the grounds of non-disclosure by the assured*".
12. Not long afterwards, in Brotherton v. Aseguradora Colseguros [2003] 2 All ER (Comm) 298, Mance LJ set about restoring some intellectual integrity to these matters.
13. Brotherton concerned the reinsurance of policies which covered losses caused by the dishonest or fraudulent acts of employees of a Colombian state-owned bank.
  - (1) The claimant reinsurers alleged that certain media reports, and investigations by the Colombian authorities into allegations of misconduct by the bank and its officials, should have been disclosed.
  - (2) The issue was whether the defendant reinsureds should be permitted to plead that the reports and investigations were immaterial because the allegations on which they were based were untrue. The Court of Appeal agreed with the Moore-Bick J at first instance that the relevant part of the pleading should be struck out.
  - (3) Mance LJ:-
    - (a) Observed (in para 12) that Pan Atlantic remains "*the most recent and authoritative exposition of the duty of disclosure*".
    - (b) Said (obviously correctly) that an offence which the individual insured has committed, but of which he has (erroneously) been acquitted can be material (para 23).
    - (c) Disagreed with Colman J's reasoning in The Grecia Express.
14. Mance LJ distilled (in para 26) the following three strands from Coleman J's reasoning:-

- (1) That the right to avoid is conditional upon the consistency of any such right to avoid with good faith or conscience.
  - (2) That an insured is, if necessary, entitled to litigate the truth or falsity of known but undisclosed intelligence in order to argue that, if shown to be incorrect, the insurer would be acting in bad faith or unconscionably in avoiding.
  - (3) That the court has a role in permitting or refusing to permit insurers to avoid a policy for non-disclosure.
15. Mance LJ rejected each of these points on grounds of policy, authority and principle, holding (at paragraph 27) that the Court did not have any discretion whether or not to permit avoidance. Furthermore, he held (in paragraph 28) that it could not be said to be bad faith for an insurer to avoid a policy for non-disclosure of otherwise material allegations on the basis that they can later be shown to be untrue. This, Mance LJ said, was contrary to the House of Lords' decision in Pan Atlantic.
16. But Mance LJ's comments on the first strand – the need for a general requirement of good faith and conscionability in the law of avoidance – were interesting. He said at paragraph 34 that:-
- (1) “[T]he mere fact that a right to rescind has an equitable origin does not mean that its exercise is only possible if that is consistent with good faith or with a court’s view of what is ‘conscionable’”.
  - (2) Recent authority has in any event tended to limit the scope of any post-contractual duty of good faith to circumstances of repudiatory breach or fraudulent intent.
17. Mance LJ's second comment was talking about a line of cases including Manifest Shipping and Agapitos.
18. In Manifest Shipping v. Uni-Polaris Shipping (The Star Sea) [2003] 1 AC 469, the alleged non-disclosure related to matters which came to the insured's knowledge after the policy had been entered into.
- (1) Insurers of a fleet of ships claimed to be entitled to avoid liability because the shipowners had failed, after the claim had been made, to disclose reports relating to earlier, similar incidents in relation to other ships in the fleet.
  - (2) Lord Hobhouse, who gave the leading speech, held that the obligation of good faith inherent in insurance contracts did not, once the contract was concluded, extend beyond requiring that any claim should not be made fraudulently.

- (3) In arriving at that conclusion, Lord Hobhouse said that avoidance of the policy “*would be totally out of proportion to the failure of which [the insurers] were complaining*” (at p. 503G).
  - (4) Lord Hobhouse further held that the obligation of good faith and disclosure, imposed by the relationship of insurer and insured, ceased to apply once the parties were engaged in hostile litigation. Instead, their relationship was governed by the rules of procedure and their substantive rights could not (with limited exceptions, such as repudiation of a contract) be affected by their conduct during litigation.
  - (5) At paragraph 57, he said: “*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*”.
19. In Agapitos v. Agnew (The Aegeon) [2003] QB 556 the Court of Appeal applied Lord Hobhouse’s conclusion in relation to the effect of litigation on the obligation of good faith, even in circumstances where the act alleged to have occurred during the litigation could be characterised as fraud or a “*fraudulent device*”. The Court refused to permit an amendment which claimed an entitlement to avoid a policy on the basis that an untrue allegation had been made by the insured during the litigation.
20. The final case I want to deal with is Drake Insurance v. Provident Insurance [2004] QB 601 concerned with a policy of motor insurance. The defendant insurer sought to avoid liability to the insurer of a motorcyclist injured by the wife of the insured (who had been named as an additional driver on the policy). There were two facts which were not disclosed, one favouring the insurer and one the insured.
  - (1) First, the insured had not disclosed a conviction for speeding.
  - (2) Secondly, the insured had disclosed, in relation to the policy for the previous year, that his wife had been involved in a “fault” accident. He did not disclose, before the relevant policy was entered into, that the claims in relation to that accident had been settled, so that it could have been reclassified as a “no fault” accident.
21. The evidence was that if the conviction had been disclosed, Provident would have charged an increased premium. At the same time, if the insured had been able to persuade the insurer that the accident could be reclassified, the increased premium would not have been charged, even if the conviction had been disclosed. Moore-Bick J held, at first

instance, that disclosure of the conviction would not automatically have led to an argument about the reclassification of the accident, so that the insurer was entitled to avoid.

22. Rix LJ, in the leading judgment, disagreed and held that Provident could not avoid:-

- (1) He held that the burden was on the insurer to prove that it had been induced to enter into the policy. Since it could not show that a higher premium would have been charged if all material facts had been disclosed, it was not entitled to avoid the policy (see para 64 on page 622).
- (2) Even if the burden had been on the insured, he could have discharged it because it was more likely than not that the status of the accident would have been discussed if the insurer had attempted to increase the premium (see para 62 on page 621).
- (3) Importantly, in discussing conclusion (1), Rix LJ said that (although he was not deciding the point) he saw no reason in principle why, just as the insurer would be entitled to rely on facts which came to his attention after the conclusion of the contract in order to avoid the policy, the insured should not be entitled to rely on facts which would have been material in his favour, if they had been disclosed (see paras 66-78).
- (4) This appears to contrast with Mance LJ's judgment in Brotherton, in which he said the insured is not entitled to prove what the true position was at the time the policy was concluded in order to show that a particular piece of information was immaterial.
- (5) Rix LJ also considered the argument that the requirement of mutual good faith precluded the insurer from avoiding the contract where it had failed to investigate the outcome of the dispute in relation to the "fault" accident. In this context Rix LJ pointed out at paragraph 89 that "*not all insurance contracts nowadays are made by those who engage in commerce. The existence of widespread insurance contracts of a consumer nature presents new problems. It may be necessary to give wider effect to the doctrine of good faith and recognise that its impact may demand that ultimately regard must be had to a concept of proportionality implicit in fair dealing*".
- (6) Pill LJ concluded, and Rix LJ and Clarke LJ declined to conclude, that Drake could show that it was a breach of its duty of good faith for Provident to avoid before asking for further information as to the status of the accident (paragraphs 91, 144,

177).

- (7) Rix LJ did, however, express the view, obiter, at paragraph 91 that knowledge or Nelsonian knowledge of the fact that the accident was a ‘no fault’ one “*would have made it a matter of bad faith to avoid the policy*” (paragraph 91, with which Clarke LJ agreed at paragraph 144). He went on at paragraph 93 to say that the difficulty is evaded if the insurer’s bad faith is used to render the non-disclosure immaterial in the first place, as Lord Hobhouse had suggested in Manifest Shipping, by saying that the courts had 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.

### Conclusions

23. It is important to understand what these cases are really about:
  - (1) First, there are numerous expressions of disquiet about the strict operation of the English law of avoidance, without delimiting any clear limitation on that operation (e.g. Staughton LJ in Kauser).
  - (2) Secondly, there is a line of cases limiting the insurer’s right to avoid for post-contract non-disclosure, and breaches of the post-contractual duty of good faith.
  - (3) Thirdly, the decision in Brotherton was about materiality. It was held that the insured was not entitled to prove what the true position was at the time the policy was concluded in order to show that a particular piece of information was immaterial. The implication of the decision was, of course, that it would not be a breach of the insurer’s duty of good faith for him to avoid a policy even if he later became aware that the true position was different from that which was material and should have been disclosed.
  - (4) Fourthly, the decision in Drake v. Provident was orthodox, namely that the non-disclosure of the speeding conviction did not, in the event, induce the contract, because of the circumstances associated with the likely discovery of the ‘non-fault’ accident.
  - (5) Fifthly, the discussion in Drake v. Provident is far from orthodox, in that it suggests that an insurer’s post-contractual actual or Nelsonian knowledge can prevent his avoiding a

policy, which he would have been entitled to avoid without that knowledge.

24. If this last point is to be the law, it would place a considerable constraint on an insurer's right to avoid. He would be forced to ask questions about the circumstances of the non-disclosure before avoiding, for fear of his avoidance being vitiated by Nelsonian knowledge. This sounds like good consumer legislation, but bad commercial law. But it is a view which has currency amongst many of the great commercial minds of our day: Clarke MR, Rix LJ, Staughton LJ, Lord Hobhouse, Staughton LJ, Longmore LJ (see his article at (2004) LMCLQ 158) and Coleman J amongst them. Lord Mance and Moore-Bick LJ seem to be dissentients.
25. The dicta in Drake v. Provident would, if correct, have far-reaching effects. They would deprive the law of avoidance of the certainty that Pan Atlantic finally instilled. Materiality is an objective matter. This attempted injection of the duty of good faith into it would deprive it of its objectivity and return us to the pre-Pan Atlantic days, when the two tests were not clearly defined

#### A final thought

26. There has been much debate in recent years about whether English law should follow the reform in Australia effected by section 21(1) of the Insurance Contracts Act 1984. That section provides that materiality is to be judged from the standpoint of the insured not the insurer. Again, it is a good piece of consumer legislation, but would it be suitable for the home of international insurance law? I think not.
27. I may be an equity lawyer, but I think that the principles of equity and discretion can be damaging to commerce if taken too far. Injecting consumer principles into the law of international business may be an error. But legislation can surely distinguish, as it does in other fields between what is applicable to consumers and what is not.
28. Is that not the solution?
29. Why should English law not provide:-
  - (1) That the duty of disclosure in a consumer insurance contract is limited to matters which are material judged from the reasonable insured's point of view; and
  - (2) That avoidance of a consumer insurance contract is limited by an element of proportionality, so that if the premium would

have been increased but the risk not declined, the insured must pay the extra premium, but would not lose his entire cover.

- (3) That an insurer may not avoid a consumer insurance contract if he has post-contractual actual or Nelsonian knowledge that the undisclosed fact would not have been material to him (or the insured).
30. I would be in favour of otherwise leaving Pan Atlantic intact for commercial insurance contracts.

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