

THE DISCLOSURE OF UNFOUNDED ALLEGATIONS IN BUSINESS INSURANCE

*Franziska Arnold-Dwyer**

Abstract: Insurance contracts are founded upon the doctrine of utmost good faith which, inter alia, requires the prospective insured to disclose material circumstances within its knowledge. This article examines the extent to which rumours in relation to, and false allegations of, dishonesty, criminality or misconduct by a business insured fall within the scope of its pre-contractual disclosure duties. If every false allegation must be disclosed, the insured may be placed in a situation where he must pay a higher premium or where he is refused insurance. Non-disclosure may entitle the insurer to avoid the contract. This article considers the current law and reform proposals in this area and argues that fairer outcomes in unfounded allegation scenarios could be achieved by adopting a proportional approach to materiality and by introducing a more flexible remedies regime.

A. INTRODUCTION

Insurance contracts are contracts based upon the doctrine of utmost good faith.¹ This doctrine imposes upon the parties a duty to observe the utmost good faith in their mutual dealings. Crucially, the doctrine also applies at the pre-contractual stage, where it imposes upon the prospective insured² a duty to make full disclosure of material circumstances which are known to the insured, and a duty to abstain from misrepresentations, before the contract of insurance is concluded.³ A breach of this duty by the insured entitles the insurer to avoid the contract ab initio, provided that the insurer can demonstrate that he was induced to enter into the contract on the terms agreed on account of the non-disclosure or misrepresentation.

It has been acknowledged in case law,⁴ academic debate⁵ and extra-judicial commentary,⁶ by consumer and industry associations⁷ and in a number of past and recent

* LL.M., Solicitor of the Senior Courts of England and Wales and M.Phil./Ph.D. candidate at the Centre for Commercial Law Studies, Queen Mary University of London. I thank Professor John Lowry for his guidance and insightful comments on earlier drafts. However, responsibility for errors is mine alone.

¹ *Carter v Boehm* (1766) 3 Burr 1905; *Bell v Lever Bros Ltd* [1932] AC 161 (HL) 227. For contracts of marine insurance this doctrine has been codified in s 17 of the Marine Insurance Act 1906 (MIA 1906). MIA 1906, ss 17-20 have also been held declaratory of the common law as regards non-marine insurance – see *Pan Atlantic Insurance Co. Ltd. v Pine Top Insurance Co Ltd* [1995] 1 AC 501 (HL) 518 (Mustill LJ).

² At the pre-contractual stage the insured is strictly speaking a ‘proposer’. To avoid confusing terminology, reference shall be made in this article to the ‘insured’ as the buyer of insurance, and the ‘insurer’ as the provider or seller of insurance protection a) at the pre-contractual stage; b) during the term of the contract of insurance; and c) following the discharge of the contract of insurance.

³ MIA 1906, ss 18, 19, and 20.

⁴ For example, see *Lambert v Co-operative Insurance Society Ltd* [1975] 2 Lloyd’s Rep 486 (CA) 491; *Kausar v Eagle Star Insurance Co* [1997] CLC 129 (CA) 132; *Drake Insurance Plc v Provident Insurance Plc* [2003] EWCA Civ 1834 [88].

Law Commission Reports and Consultation Papers⁸ that the insured's pre-contractual duty of disclosure places upon the insured a disproportionately heavy burden and that the scope of this duty is poorly understood amongst insureds. Moreover, a breach of the duty has drastic economic consequences for the insured in that, if the insurer successfully avoids the policy, the insured will be without insurance protection and cannot claim for losses incurred under that policy. For those reasons, the pre-contractual duty of disclosure has now been abolished for consumer insureds under the Consumer Insurance (Disclosure and Representations) Act 2012 (the 2012 Act). Broadly speaking, consumers are natural persons acting for purposes outside their trade, business or profession.⁹

However, for business insureds the pre-contractual duty of disclosure remains an onerous one. The onus of the business insureds' duty comes into sharp focus in relation to the necessity to disclose unfounded rumours concerning the integrity of the insured and false allegations of dishonesty, criminality or misconduct by the insured.¹⁰ The facts of *North Star Shipping Ltd v Sphere Drake Insurance Plc*¹¹ (*The North Star*) serve as a good illustration of the issue: at the time the policy was entered into there were pending criminal fraud charges against the owners and managers of the insured and civil fraud claims against a parent company of the insured. The insured did not disclose any of these allegations to the insurer. After placing the contract and before the insurer sought to avoid the contract, the criminal charges were dismissed and the civil fraud claims were dropped.

In this type of scenario, the courts have to decide whether the unfounded allegations are material for the purposes of the insured's pre-contractual duty of disclosure. If every false allegation must be disclosed, the insured may be placed in a situation where he must pay a higher premium or is refused insurance. Moreover, if at the time of the purported avoidance it

⁵ RA Hasson, 'The Doctrine of Uberrima Fides in Insurance Law – a Critical Evaluation' (1969) 32 MLR 615; John Lowry, 'Redrawing the Parameters of Good Faith in Insurance Contracts' [2007] CLP 338; John Lowry and Philip Rawlings, 'That wicked rule, that evil doctrine: Reforming the Law on Disclosure in Insurance Contracts' [2012] 75(6) MLR 1099.

⁶ Sir Andrew Longmore, 'An Insurance Contracts Act for a New Century' [2001] LMCLQ 356

⁷ John Birds, 'Insurance Law Reform: the consumer case for review of insurance law' National Consumer Council, (May 1997); British Insurance Law Association, 'Insurance Contract Law Reform – Recommendations to the Law Commissions' (2002); Airmic, 'Non-disclosure of Material Facts and Information in Business Insurance – a Guide' (June 2011).

⁸ The Law Commission, *Insurance Law: Non-Disclosure and Breach of Warranty* (Law Com No 104, 1980); The Law Commission and The Scottish Law Commission, *Misrepresentation, Non-disclosure and Breach of Warranty by the Insured* (Law Com CP No 182, July 2007); *Consumer Insurance Law: Pre-contract Disclosure and Misrepresentation* (Law Com Rep No 319, December 2009); *Insurance Contract Law: The Business Insured's Duty of Disclosure and the Law of Warranties* (Law Com CP No. 204, June 2012).

⁹ Consumer Insurance (Disclosure and Representations) Act 2012 (the 2012 Act), s 1(a).

¹⁰ In this article collectively referred to as unfounded allegations.

¹¹ *North Star Shipping Ltd v Sphere Drake Insurance Plc (The North Star)* [2006] EWCA Civ 378, [2006] 2 Lloyd's Rep 183.

can be shown that the rumours or allegations which were outstanding at the time of placement were in fact unfounded, it is arguable that the insurer has not been prejudiced by not being informed about such rumours and allegations at the time of placement. On the other hand, an insurer is entitled to a fair presentation of the risk which may extend to information that “raises doubts about the risk” such as rumours or allegations.¹² A prudent insurer is “likely to take the view there is no smoke without fire”¹³ when confronted with a rumour or allegation of dishonesty or criminal conduct and may therefore make an underwriting decision not to accept the relevant risk or to charge a higher premium or to impose special terms in relation to the rumour or allegation.

As will become apparent below, in addressing these issues, different judges have come to different conclusions. Moreover, academic commentary has elicited possible solutions to protect the insured within and outside the confines of the existing law. It is also important to note that the whole area of pre-contractual disclosure has recently been subject to a law reform review conducted by the Law Commission and the Scottish Law Commission (together, the “Law Commission”) which, to date, in relation to consumer insurance, has culminated in the enactment of the 2012 Act.

This article is concerned with the business insured’s duty of pre-contractual disclosure in relation to unfounded allegations and any references to the term “insured” and “insurance” should be understood as “business insured” and “business insurance” respectively unless stated otherwise. It does not consider the position of consumer insureds other than by way of comparison. In Part B, this article examines the applicable legal principles and the case law relating to the disclosure of unfounded allegations. In Part C, this article then critically assesses reform proposals aimed at limiting the application of the duty of disclosure in relation to unfounded allegations and the availability of the remedy of avoidance. It will be argued that grave injustice in many unfounded allegation cases could be avoided by adopting a proportional approach to materiality and by introducing a more flexible remedies regime.

This article does not consider the insured’s pre-contractual duty not to make false representations as to matters of material fact, expectation or belief;¹⁴ also beyond the scope of this article is the consideration of pre-contractual disclosure by agents of the insured.

¹² *Inversiones Manria SA v Sphere Drake Insurance Co Plc, Malvern Insurance Co Ltd and Niagara Fire Insurance Co Inc (The Dora)* [1989] 1 Lloyd’s Rep 69, 98.

¹³ *The North Star* (n 11), para 17 (Waller LJ).

¹⁴ Marine Insurance Act 1906 (MIA 1906) s 20.

C. THE LEGAL PRINCIPLES

1. *The Common Law and the Marine Insurance Act 1906*

In *Carter v Boehm*, Lord Mansfield CJ set out the scope of the pre-contractual duty of disclosure:

“Insurance is a contract of speculation. 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 circumstances in his knowledge, to mislead the underwriter into a belief that the circumstance does not exist, and to induce him to estimate the risque, as if it did not exist ... Good faith forbids either party, by concealing what he privately knows, to draw the other into a bargain, from his ignorance of that fact, and his believing to the contrary.”¹⁵

The pre-contractual duty of disclosure of the insured in contracts of marine insurance has been codified in section 18 of the Marine Insurance Act 1906 (MIA 1906). This provision has been held declaratory of the common law as applicable to non-marine insurance contracts.¹⁶

From the provisions in section 18 a number of principles relating to the duty of disclosure have been extrapolated. First, the duty of disclosure applies until the contract is concluded. Secondly, only “material circumstances” need to be disclosed. “Materiality” is a question of fact determined in accordance with the test set out in s.18(2), namely whether a (non-disclosed) circumstance would influence the judgment of a prudent insurer in fixing the premium, or determining whether he will take the risk. Thirdly, the insured is only required to disclose material circumstances which are known to him or which, in the ordinary course of business, ought to be known to him.¹⁷ Fourthly, s.18(3) enumerates a number of circumstances which do not need to be disclosed in the absence of inquiry.¹⁸ Fifthly, the insurer’s remedy for a breach of the duty of disclosure by the insured is avoidance. Finally, it is important to note that, in addition to the provisions of s.18 of MIA 1906, the courts introduced a requirement of “inducement”. In *Pan Atlantic Insurance Co. Ltd. v Pine Top Insurance Co Ltd* the House of Lords held that, in order to prove a breach of the duty of disclosure, it must be demonstrated that the actual insurer was induced to enter into the

¹⁵ *Carter v Boehm* (n 1), 1909.

¹⁶ See (n 1).

¹⁷ If the insured is not ‘in business’, e.g. in the instance of a consumer insured, no deemed knowledge is attributed. See *Economides v Commercial Union Assurance Co Plc* [1998] QB 587 (CA).

¹⁸ These circumstances are a) circumstances which diminish the risk; b) any circumstances known or presumed to be known by the insurer; c) circumstances as to which disclosure has been waived by the insurer; and d) circumstances covered by warranty.

contract of insurance on the terms agreed by the non-disclosure of a material circumstance.¹⁹ For the purposes of the subsequent discussion, it is necessary to explore the notions of materiality and inducement and the remedy of avoidance in more detail:

a) Materiality

According to section 18(2) the test of whether a (non-disclosed) circumstance is material is whether or not it would have influenced the judgment of a prudent insurer in fixing the premium, or determining whether he would take the risk. This test is also referred to as the “prudent underwriter test”. The influence on the judgment of the insurer need not be “decisive” in the sense that the disclosure of the circumstance would have caused the charge of an increased premium or the decline of the risk. The judgment of a prudent insurer is considered to have been “influenced” if disclosure of the circumstance would have “an effect on the thought processes of the insurer in weighing up the risk”.²⁰ Materiality, being a question of fact, is assessed by the courts often with the assistance of expert evidence.²¹ Specific instances of material circumstances will depend on the type of insurance and tend to fall into two broad categories: (1) physical risk factors which increase the risk of loss of the insured subject-matter (i.e. a claim) and (2) so-called moral hazards which are matters that affect the integrity of the insured and thereby increase the likelihood of false claims being made under the policy.²²

b) Inducement

The actual insurer must prove that he was induced to enter into the contract of insurance on the terms agreed by the non-disclosure of a material circumstance.²³ Whilst the non-disclosure need not be the sole inducement, the non-disclosure must be an “effective cause” to the particular insurer entering into the contract.²⁴ Inducement is not established if the insurer would only have wanted to ask further questions.²⁵

¹⁹ *Pan Atlantic* (n 1) 549 (Mustill LJ).

²⁰ *ibid* 531 (Mustill LJ).

²¹ Such expert evidence is, however, not conclusive: see *Brotherton v Aseguradora Colseguros (No.2)* [2003] EWCA Civ 705, [2003] 2 All ER 298 [28]. The court may also decide on materiality without the benefit of expert evidence: see *Synergy Health (UK) Ltd v CGU Insurance Plc* [2010] EWHC Comm 2583, [2011] Lloyd's Rep IR 500 [152].

²² *Insurance Corporation of the Channel Islands v The Royal Hotel Ltd* [1998] Lloyds Rep IR 151 (QB) 156.

²³ *Pan Atlantic* (n 1).

²⁴ *Assicurazioni Generali SpA v ARIG* [2002] EWCA Civ 1642, [2003] 1 WLR 577, paras 62, 78, 215-221.

²⁵ *O'Kane v Jones* [2003] EWHC Comm 2158, [2004] 1 Lloyd's Rep 389, para 235.

c) Remedy of Avoidance

On a breach of the insured's duty of disclosure, the insurer may avoid the contract of insurance. If the insurer elects to avoid, such avoidance is retroactive: the contract is avoided ab initio and all claims and premiums already paid must be returned.²⁶ The right of avoidance is the only remedy available to the insurer in the circumstances²⁷ and can be lost, for example by affirmation or the operation of estoppel.

2. Case Law Relating to Unfounded Allegations

The two leading authorities on disclosability of (unfounded) allegations are the Court of Appeal decisions in *Brotherton v Aseguradora Colseguros (No.2)*²⁸ and *The North Star*²⁹. The facts of *Brotherton* were as follows: the defendant, a local fronting insurance company, had issued a banker's blanket bond insurance to a Colombian bank. The reinsurer sought to avoid the contract of reinsurance on the grounds of non-disclosure, claiming that at the time of the conclusion of the contract allegations of serious misconduct and fraud on the part of senior staff of the bank had been raised in media reports, which eventually led to disciplinary and criminal proceedings. The reinsurers alleged that the allegations were material because they increased the likelihood of a claim and because they were suggesting moral hazard. They sought a declaration that they were entitled to avoid the contract. The insurer argued that the allegations made had been politically motivated and that nearly all proceedings had been concluded in favour of the bank's officials, although a few were still pending, at the time of the purported avoidance and, accordingly, the allegations had not been material. On an application by the reinsurers, the first instance judge held that the insurer could not adduce post-contract evidence which showed that the allegations were unfounded.

The main issues on appeal before the Court of Appeal were (1) the materiality of the allegations, and (2) whether the validity of the avoidance depended on the correctness of the allegations and whether there was actual misconduct justifying the allegations. The Court of Appeal dismissed the appeal and decided both issues in favour of the reinsurers. Giving the leading judgment, Mance LJ held that the allegations were "circumstances" within the meaning of ss. 18(1) and 18(5) of MIA 1906. As for materiality, he referred to long-

²⁶ In the case of fraud, premium may not be returnable on avoidance – MIA 1906 (n 3), s 84(5).

²⁷ *Banque Keyser Ullmann SA v Skandia (UK) Insurance Co Ltd* [1991] 2 AC 249, 274.

²⁸ *Brotherton v Aseguradora Colseguros (No.2)* [2003] EWCA Civ 705, [2003] 2 All ER 298. *Brotherton* is a reinsurance case. However, as the insurer was no more than a fronting insurance company interpolated to comply with local law requirements, and reinsured at 100%, it is argued that this decision is highly authoritative in respect of insurance cases.

²⁹ *The North Star* (n 11).

established authorities³⁰ that intelligence and well-founded rumours (as distinct from “loose or idle rumours”) relating to the physical risk factors may be material whether or not they are true. As the reinsurers had argued materiality by reference to physical and moral hazards, Mance LJ then proceeded to say that he could see no reason why information known to the insured suggesting the possibility of moral hazard should not be capable of being material in the *Pan Atlantic* sense.³¹ This settled a point on which different views had been expressed previously in a series of first instance decisions.³² Mance LJ cited with approval Phillips J in *The Dora*:

“When accepting a risk underwriters are properly influenced not merely by facts which, with hindsight, can be shown to have actually affected the risk but with facts that raise doubts about the risk”.³³

Both Mance LJ, and Buxton LJ in his supporting judgment, rejected the proposition that the test for the disclosure of unfounded allegations focuses on the need for actual prejudice to the insurer if such allegations were not to be disclosed.³⁴ Citing *Carter v Boehm*³⁵ as authority, Mance LJ noted that the “philosophical basis” for the duty of disclosure is that “a true and fair agreement for the transfer of risk on an appropriate basis depends on equality of information”.³⁶ Similarly, Buxton LJ explained that, if no disclosure of unfounded allegations were to be made, the insurer would lose the opportunity to take an informed decision at the time of placement.³⁷

The Court of Appeal also confirmed that materiality is to be tested at the time of placing the risk by reference to the circumstances known to the insured at that date.³⁸ Therefore, circumstances did not cease to be material because it could ultimately be shown that what was alleged was incorrect. However, Mance LJ added that both materiality and inducement would in all likelihood be assessed on the basis that, had disclosure taken place,

³⁰ *Brotherton* (n 28), paras 16-17. Mance LJ cited *De Costa v Scandret* (1823) 2 Eq Ca Ab 636; *Seaman v Fonereau* (1743) 2 Stra 1183; *Lynch v Hamilton* (1810) 3 Taunt 15; *Lynch v Dunsford* (1811) 14 East 494; *Durrell v Bederley* (1816) Holt 283; *Morrison v Universal Marine Insurance Co* (1872-3) LR 8 Exch 40 and 197 and MIA 1906 s18(5) but noted that only in *Lynch v Hamilton* was the intelligence incorrect in fact.

³¹ *Brotherton* (n 28), para 21; *Pan Atlantic* (n 1).

³² May J in *March Cabaret Club & Casino Ltd v The London Assurance* [1975] 1 Lloyd's Rep 169 (QB), Phillips J in *The Dora* (n 12) and Colman J in *Strive Shipping Corp v Hellenic Mutual War Risks Association (The Grecia Express)* [2002] EWHC (Comm) 203, [2002] 2 Lloyd's Rep 88 took the view that an unfounded allegation could be material. Forbes J in *Reynolds v Phoenix Assurance Co Ltd* [1978] 2 Lloyd's Rep 440 took the opposite view.

³³ *The Dora* (n 12) 93.

³⁴ *Brotherton* (n 28), paras 19, 23 and 40.

³⁵ *Carter v Boehm* (n 1).

³⁶ *Brotherton* (n 28), para 24.

³⁷ *ibid*, para 40.

³⁸ *ibid*, para 18.

it would have embraced all matters within the knowledge of the insured at the time of placing, including his own statement of his innocence and any exculpatory evidence available.³⁹ In effect, Mance LJ conceded that the exculpatory information could diminish or even negate the materiality of an unfounded allegation, if such information was within the knowledge of the insured at the time of placement.

The Court of Appeal rejected the insurer's argument that the reinsurers could be deprived of their right to avoid for material non-disclosure of allegations by the insurer demonstrating with hindsight at trial that the allegations were false. Mance LJ said that such a conclusion was neither supported by "principle nor sound policy"⁴⁰, the point of policy being that it would be undesirable to allow an insured to litigate the issue of the truth or falsity of the allegation.⁴¹ The Court of Appeal commented in unfavourable terms on the reasoning in *The Grecia Express*⁴² where Coleman J had held that it would be contrary to an insurer's obligation of utmost good faith to seek avoidance in the face of evidence that the undisclosed allegations were in fact unfounded and that it would be unconscionable for the court to permit the insurer to avoid.⁴³ By analogy to the law of rescission in general contract law, Mance LJ considered the right to avoid to be a self-help remedy. Accordingly, the court had no role to play in permitting or refusing to permit its exercise.⁴⁴ He doubted that the exercise of the right to avoid by the (re)insurer was subject to a requirement of good faith but the Court of Appeal did not rule out expressly that an insurer could be denied the remedy of avoidance where the insurer was aware that the undisclosed allegations were unfounded at the time of the purported avoidance.⁴⁵ The trial judge, Morrison J, applying the guidelines given by the Court of Appeal, found that the media reports went far beyond idle rumours and amounted to material allegations that ought to have been disclosed.⁴⁶

The relevant facts of *The North Star* have been summarised above.⁴⁷ The Court of Appeal held that the allegations of fraud constituted a moral hazard and were material, even though they ultimately turned out to be untrue, as at the time of placing such allegations would have affected the mind of a prudent insurer. In *The North Star* it was argued by the insured that only allegations giving rise to moral hazard which were material to the actual

³⁹ *ibid*, para 22.

⁴⁰ *ibid*, paras 26 and 29.

⁴¹ *ibid*, para 31.

⁴² *The Grecia Express* (n 32).

⁴³ *Brotherton* (n 28), para 23.

⁴⁴ *ibid*, para 27. This conclusion has been criticised – see text to n 127.

⁴⁵ *The Grecia Express*, paras 28 and 34.

⁴⁶ *Brotherton v Aseguradora Colseguros (No.3)* [2003] EWHC Comm 1741, [2003] Lloyd's Rep IR 762.

⁴⁷ See text to n 11.

risk insured had to be disclosed. Waller LJ, who gave the leading judgment, concluded, with some regret, that there was no basis for this argument, as the orthodox test applicable to materiality remains the “prudent underwriter test”⁴⁸ which is not circumscribed by any notion of relevance of the disclosable circumstance to the risk insured. Waller LJ observed that unless, at the time of placing, there was very clear evidence that the allegation was unfounded the insurer was entitled to disclosure.⁴⁹ However, he conceded that “old allegations of dishonesty and allegations of not very serious dishonesty” may not be material.⁵⁰ He further conceded that non-payment of premium might not be material as it “seems to go to the owner’s credit risk, and not to the risk insured”.⁵¹ Although, as noted above, Waller LJ rejected a general relevance qualification to the “prudent underwriter test”, it is submitted that these concessions add to the test an implicit notion of proportionality. The Court of Appeal declined to comment on whether the right to avoid for non-disclosure might be constrained for being contrary to good faith where the insurer knows at the time of the purported avoidance that the undisclosed allegations were in fact unfounded.

There are two further cases which merit brief discussion. First, *Drake Insurance Plc v Provident Insurance Plc*⁵² is a case which, although not directly on point factually, considers a number of issues which are relevant to unfounded allegation scenarios. In *Drake* the defendant insurer had purported to avoid a policy of motor insurance for non-disclosure of a speeding conviction. The first instance judge found as a fact that, if the speeding conviction had been disclosed at the time of placing, it would have also emerged that a separate “fault” accident on the insured’s records should have been reclassified as “no fault”.⁵³ On the insurer’s point rating system used for the calculation of premium, the reclassification of that accident would have cancelled out the speeding conviction and would have resulted in a premium reduction. The Court of Appeal held that, because the two circumstances would have cancelled each other out, the insurer could not show that he would have charged a higher premium and, therefore, failed to discharge the burden of proof on inducement and was not entitled to avoid. *Drake* underlines that the courts are prepared to consider what the reaction of the actual insurer might have been if disclosure had been made. By analogy to *Drake*, it is conceivable for an unfounded allegation case to fail on inducement if the true position would have been established following further pre-contractual discussions of the

⁴⁸ *The North Star* (n 11), para 18.

⁴⁹ *ibid*, paras 17 and 35.

⁵⁰ *ibid*, para 19.

⁵¹ *Ibid*, para 50.

⁵² *Drake Insurance Plc v Provident Insurance Plc* [2003] EWCA Civ 1834, [2004] QB 601.

⁵³ *Drake Insurance Plc v Provident Insurance Plc* [2003] EWHC Comm 109, [2003] 1 All ER 759, para 27.

allegations and any exculpatory materials. In practice, the *Drake* inducement test depends on hypothetical facts about how the insurer would have reacted to the “true position” and how the insured would have responded to the insurer’s reaction, such as an increased quotation or special terms.

Rix LJ, giving the leading majority judgment, considered obiter and “with caution” that materiality had to be assessed by reference to the true state of affairs underlying the risk “conclusively established” at the time of the contract, and not just on the basis of information actually provided to the insurer.⁵⁴ The significance of this statement in relation to unfounded allegations is that any exculpatory material available at the time of the contract may negate the materiality of an unfounded allegation. This is consistent with Mance LJ’s comments in *Brotherton*.⁵⁵ However, as Waller LJ pointed out in *The North Star* the decision in *Drake* may be of assistance to the insured in very few cases, namely where the pre-contract exculpatory facts, and their effect, can be ascertained, for example by reference to a point rating system as used by the insurer in *Drake*.⁵⁶ Thus, in *Brotherton*, the exculpatory matters relied upon (the fact that nearly all proceedings had been concluded in favour of the bank’s officials) had occurred only after the contract of reinsurance had been concluded. It had not been argued that the allegations were unfounded at the time of the contract.

In *Drake* the Court of Appeal also re-examined the question whether the insurer’s right to avoid is limited by the doctrine of good faith. Obiter, Rix and Clarke LLJ both tentatively expressed the view that, as a principle of fair dealing, the right of avoidance is fettered by the requirement to exercise it in good faith.⁵⁷ In that respect, Rix LJ opined that the doctrine of utmost good faith should be given wider effect by having regard to a concept of proportionality.⁵⁸ Accordingly, if it had been shown on the facts that the insurer had (blind eye) knowledge of the fact that the earlier accident was “no fault” at the time of avoidance, the exercise of the right to avoid would have been in bad faith.

Extending the majority’s views to unfounded allegation cases, it seems arguable that an insurer who intends to avoid for non-disclosure of an allegation but, prior to the exercise of its right to avoid, learns that the allegation is unfounded, may be prevented from avoiding by the doctrine of good faith. This approach does not sit easily with the unfavourable comments made by Mance LJ in respect of a requirement to exercise the right to avoid in

⁵⁴ *Drake* (n 52), paras 69-77. Pill LJ dissenting on this point – see para 163.

⁵⁵ See text to ns 38-39.

⁵⁶ *The North Star* (n 11), para 17.

⁵⁷ *Drake* (n 52), paras 87 and 91 (Rix LJ), para 144 (Clarke LJ).

⁵⁸ *ibid*, para 89.

good faith or conscionably.⁵⁹ Davey has suggested that the dicta in *Drake* can be reconciled with Mance LJ's view in *Brotherton*. He points out that *Brotherton* can be distinguished on the ground that the case was concerned with allegations that remained unresolved post-avoidance and up to the moment of litigation and that Mance LJ had not expressed any view on cases where the true facts were established prior to avoidance.⁶⁰ However, the authors of 'Arnould's Law of Marine Insurance and Average' consider this distinction to have no bearing on the issue of principle as to whether a duty of good faith attaches to the exercise of the right of avoidance, only when and how the duty might arise, if it exists, and consequently they consider this point as "open on the authorities".⁶¹ The difference in approach between *Drake* and *Brotherton* to the insurer's duty of good faith has also been noted by Lowry, Rawlings and Merkin who prefer the reasoning in *Brotherton* as being in line with the general contract law on rescission and the current judicial trend towards "eroding the harshness of the duty of utmost good faith".⁶² It is submitted that the reasoning in *Brotherton* is to be preferred as a matter of legal principle: if there has been a breach of the duty of good faith by the insured, it is conceptually problematic to maintain that this breach can be cancelled out by the insurer's exercise of his remedy to avoid.⁶³ It is acknowledged that the insistence on principle may not do justice to the insured and in this respect reference is made to Part C of this article.

Finally, in *Norwich Union Insurance Ltd v Meisels*⁶⁴ the insurer sought to avoid the contract for a number of reasons, including on the ground that the insured had failed to disclose allegations made by the Inland Revenue against one of the insured's companies in relation to unpaid taxes and penalties and the dissolution of a number of the insured's companies for failing to file accounts. In respect of the last failing, the insured, as an officer of the relevant companies, could have been guilty of a criminal offence under s.221(5) of the Companies Act 1985. Tugendhat J confirmed that *Brotherton* was authority for the proposition that the materiality of an unfounded allegation could be negated by reference to all aspects of the insured's knowledge at the time of placing, including any exculpatory materials.⁶⁵ He rejected an argument by the insurer that *The North Star* had introduced a gloss

⁵⁹ See text to ns 44-45.

⁶⁰ James Davey, 'Materiality, non-disclosure and false allegations: following *The North Star*?' [2006] LMCLQ 517, 536.

⁶¹ Jonathan Gilman and others, *Arnould's Law of Marine Insurance and General Average* (17th edn, Sweet & Maxwell 2008), paras 15-165.

⁶² John Lowry, Philip Rawlings and Robert Merkin, *Insurance Law: Doctrines and Principles* (3rd edn, Hart Publishing 2011) 126.

⁶³ This conceptual difficulty was acknowledged by Rix LJ in *Drake* (n 52), paras 88 and 93.

⁶⁴ *Norwich Union Insurance Ltd v Meisels* [2006] EWHC QB 2811, [2007] 1 All ER 1138.

⁶⁵ *Norwich Union Insurance Ltd v Meisels* (n 64), para 11 and see *Brotherton* (n 28), para 22.

to *Brotherton* such that, to have a materiality-negating effect, the exculpatory materials had to be capable of proving the allegation to be false “beyond peradventure” at the time of the contract.⁶⁶ He concluded that the weight of the exculpatory materials and, consequently, the extent to which it could negate the materiality of unfounded allegation, would “depend on all the circumstances known to the insured” at the time of the contract.⁶⁷ In addition, Tugendhat J expressly referred to a notion of proportionality when assessing the materiality of allegations, “having regard to the nature of the risk and the moral hazard under consideration”.⁶⁸ Therefore, allegations which are too old or insufficiently serious may not be material, regardless of exculpatory materials being available.⁶⁹ He also drew a distinction between allegations of dishonesty and allegations of criminality not involving dishonesty.⁷⁰

Meisels is a High Court decision and as such not binding on the higher courts. However, it is submitted that the Court of Appeal has already recognised implicitly a notion of proportionality: in *The North Star* Waller LJ observed that allegations that are old or of not very serious dishonesty may not be material,⁷¹ and in *Brotherton* Mance LJ excluded “loose or idle rumours” as not being material.⁷² Accordingly, it could be argued that the combined effect of *Brotherton*, *The North Star* and *Meisels* is that there is now an emerging principle of proportionality which narrows the range of allegations which could be potentially material. A criminal charge the insured knows to be true is likely to require disclosure. Unfounded allegations which are merely loose rumours, trivial and old allegations, allegations that do not raise issues of dishonesty and allegations to which the insured would have had a cogent defence at the time of the contract may not be material. Further, materiality is mitigated by the requirement of inducement which, following *Drake*, is determined by how the actual insurer would have reacted if disclosure of the unfounded allegation had been made, although this may be difficult to ascertain in practice. Whilst *Brotherton* makes it clear that an insurer cannot be deprived of its right to avoid for material non-disclosure of allegations by the insured demonstrating at trial that the allegations were false, it is presently unresolved whether an insurer can be denied that right if, in breach of his duty of good faith, he seeks to avoid with the knowledge that the undisclosed allegation was unfounded.

⁶⁶ *The North Star* (n 11), para 17.

⁶⁷ *Norwich Union Insurance Ltd v Meisels* (n 64), para 25.

⁶⁸ *ibid.*

⁶⁹ *ibid.*

⁷⁰ *ibid.*, para 40.

⁷¹ *The North Star* (n 11), para 19.

⁷² *Brotherton* (n 28), para 16.

D. REFORM

1. *The Case for Reform*

In *The North Star* Waller LJ acknowledged that “there is something unjust” in the notion that an insurer may have grounds for avoidance on account of undisclosed allegations against the insured which are in fact unfounded.⁷³ First, the insured may not be aware that an allegation he knows to be untrue may be material and therefore disclosable.⁷⁴ Secondly, the obligation to disclose an unfounded allegation under the current law presents the insured with a difficult choice: he must either (1) disclose an unfounded allegation thereby risking being refused insurance cover or being charged a higher premium on account of such allegation, or (2) withhold such information from the insurer thereby risking that the insurer may subsequently seek avoidance of the contract of insurance thereby leaving the insured without cover for claims. Thirdly, there is also the paradox noted by Forbes J in *Reynolds v Phoenix Assurance Co Ltd* that the rule requiring allegations to be disclosed applies only to unfounded allegations.⁷⁵ If the allegation were true then the insured would be required to disclose that he had committed the fraud (or crime) and the disclosure of the allegation added nothing.⁷⁶ Fourthly, the disclosure to the insurer of allegations of criminal conduct, whether true or false, is not easily reconciled with the criminal law principle of the presumption of innocence.⁷⁷ Fifthly, it is perplexing that an insured would be excused from disclosing a spent conviction for fraud under the Rehabilitation of Offenders Act 1974 but may be required to disclose an allegation of criminality before he is even tried.⁷⁸ Finally, it could be argued that, in particular in scenarios where a claim has been made under the policy, an insurer who seeks to avoid on the grounds of non-disclosure of an allegation he knows to be untrue acts opportunistically. As a matter of policy, such behaviour should be discouraged because it can be wasteful and exploitative.

Thus, there are a multitude of reasons why the duty to make disclosure of unfounded allegations might operate unjustly and, accordingly, there seems to be a prima facie case for reform. However, any changes to the current law must also take into account the insurer’s

⁷³ *The North Star* (n 11), para 4.

⁷⁴ This is a general criticism of the duty of disclosure which has been raised and/or acknowledged by the courts, commentators and the Law Commission (ns 4-8).

⁷⁵ *Reynolds v Phoenix Assurance Co Ltd* (n 32) 460.

⁷⁶ *ibid.* Forbes J concluded that this is “a conclusion so devoid of merit that I do not consider that a responsible insurer would adopt it and nor do I”. As has been shown in Part B of this article, *Brotherton* and *The North Star* are authorities for the proposition that an unfounded allegation itself may be material for disclosure.

⁷⁷ i.e. the principle that a person is innocent until proven guilty. See M Clarke, ‘Refusing Recission? Contracts of Utmost Bad Faith’, (2003) 62 CLJ 556, 557.

⁷⁸ This is a point made in in Nicholas Legh-Jones, John Bird and David Owen, *MacGillivray on Insurance Law* (10th edn, Sweet & Maxwell 2003), para 17-058.

need for a fair presentation of the risk upon which it has been held a fair agreement for the transfer of risk is dependent.⁷⁹ In evaluating reform proposals regard must also be given to general policy considerations, such as legal certainty in commercial dealings⁸⁰ and the competitiveness and efficient operation of the English insurance market.⁸¹

2. Judicial Intervention

To change the law on the disclosure of unfounded allegations two mechanisms may, in principle, be available: judicial intervention and legislation. As regards judicial intervention, the courts' ability to develop the law on the duty of disclosure and the remedy of avoidance has been hampered by the codification of the law on non-disclosure in ss.18-19 of the MIA 1906.⁸² The courts cannot disapply the MIA 1906 but in practice they have developed the law in this area on a case-by-case basis via statutory interpretation and by reference to the common law.⁸³ As has been shown in Part B of this article, whilst recognising the perceived harshness of the duty of disclosure in unfounded allegation cases, the courts' efforts to mitigate its effects have been muted.⁸⁴ Thus, Waller and Longmore LJ in *The North Star* expressly acknowledged the need for more far-reaching reform but preferred to leave this matter to the Law Commission.⁸⁵

Academic opinion on the courts' approach to unfounded allegation cases is diverse: the authors of 'Arnould's Law of Marine Insurance and Average' do not welcome the tentative judicial inroads made in respect of (1) the potentially materiality negating effect of exculpatory material as introducing an "unacceptable level of uncertainty" and (2) good faith limiting the right to avoid as having "no proper conceptual basis"⁸⁶ but, as will be seen below, other commentators' proposals have sought to build upon the judicial inroads already made into the orthodox position.

⁷⁹ *Carter v Boehm* (n 1); *Brotherton* (n 28) and text to n 36.

⁸⁰ Davey (n 60), 518.

⁸¹ In an Impact Assessment, the Law Commission found that the current law adversely impacts the capacity of the insurance market to operate efficiently – see The Law Commission, *Updating insurance contract law: the business insured's duty of disclosure* (Impact Assessment June 2012), paras 3-7.

⁸² Law Com CP 204 (n 8), para 4.82.

⁸³ For example, the courts have sought to soften the harshness of the duty of disclosure (1) by superimposing the requirement of inducement (see text to ns 19, 22-24): *Pan Atlantic* (n 1); *Assicurazioni Generali SpA v ARIG* (n 24); *O'Kane v Jones* (n 25); (2) by developing concepts of waiver based on either the questions asked by the insurer or the insurer reasonably being put on notice (*Hair v Prudential* [1983] 2 Lloyd's Rep 667 (QB); *O'Kane v Jones* (n 25)); and (3) by exploring limits to the remedy of avoidance (see text to ns 44-45, 57-59).

⁸⁴ See in particular discussion in Part B on *Brotherton*, *The North Star* and *Drake*.

⁸⁵ *The North Star* (n 11), para 20 (Waller LJ) and para 54 (Longmore LJ).

⁸⁶ *Arnould's Insurance* (n 61), paras 15-113 and 15-156-15-165.

In this section, a number of areas potentially suitable for judicial intervention will be considered: a relevance qualification to materiality, proportionality, judicial control of expert evidence, inducement and the remedy of avoidance.

a) Relevance

The court in *The North Star* considered the insured's argument that allegations of dishonesty unrelated to the risk were immaterial, but ultimately rejected this approach as being inconsistent with the "prudent underwriter test" in the *Pan Atlantic* sense.⁸⁷ There is some judicial and academic support for the proposition that the notion of "materiality", in addition to satisfying the "prudent underwriter test", also requires the circumstance to have an objective connection to the risk.⁸⁸ However, other judges have adhered to the "prudent underwriter test" as the exclusive test for materiality.⁸⁹ A "relevance qualification" may reign in the width of the duty of disclosure by excluding from its scope circumstances that are only of commercial or emotional relevance to the insurer but are unrelated to the risk.⁹⁰ However, it is submitted that it is a difficult concept to apply to incidents of moral hazard because the notion of moral hazard comprises matters which go beyond the risk of the insured subject-matter being lost or damaged and extends to matters which merely increase the risk of a false claim being made.⁹¹ If relevance is tested against a notion of risk in the narrow sense (i.e. the risk of the occurrence of an insured peril), this would remove from the scope of disclosure most incidents of moral hazards, including matters such as the insured's claim records⁹², insolvency⁹³ and unspent criminal convictions⁹⁴ which the courts have held should be included in a fair presentation of the risk and which the Law Commission considers to be part of the standard information which market participants generally understand to be disclosable in order to give a fair presentation of the risk.⁹⁵ On the other hand, if a wider meaning of risk (including both the risk of the occurrence of an insured peril and the risk of a false claim

⁸⁷ *The North Star* (n 11), para 18.

⁸⁸ *SAIL v Farex Gie* [1994] CLC 1094, 1111 (Hoffman LJ); see also *O'Kane v Jones* (n 25) para 222. The High Court of Australia decided in *Permanent Trustee v FAI General Insurance Co Ltd* [2003] HCA 25 that disclosure under Australian law did not extend to matters unrelated to the insurance risk, as requiring disclosure of such matters would impose an impractical burden on the insured and would allow the law to be used as a 'charter for avoidance'. Also see Peter MacDonald Eggers, Simon Picken and Patrick Foss, *Good Faith and Insurance Contracts* (3rd edn, Lloyd's List 2010), paras 14.70-14.77.

⁸⁹ *SAIL v Farex Gie* (n 86) 1101 (Dillon LJ).

⁹⁰ *Permanent Trustee* (n 88).

⁹¹ *Insurance Corporation of the Channel Islands v The Royal Hotel* (n 22) 156.

⁹² *Marc Rich & Co v Portman* [1997] 1 Lloyd's Rep 225.

⁹³ *Sugar Hut Group Ltd v Great Lake Reinsurance (UK) Plc* [2010] EWHC Comm 2636, [2011] Lloyd's Rep IR 198.

⁹⁴ *Lambert v Co-Operative Insurance Society* (n 4).

⁹⁵ Law Com CP 204 (n 8), paras 5.15-5.27 and 5.79.

being made by the insured) is adopted, a relevance qualification would be of little benefit to the insured where allegations of dishonesty have been raised, because such allegations would in most cases be seen as relevant to the risk of loss under the policy: an allegation of dishonesty points towards a potential propensity of the insured to act dishonestly, which increases the risk of a loss being sustained through the fraudulent design of the insured.⁹⁶ Midwinter argues that an allegation which the insured knows to be untrue at the time of the placement is not material because by virtue of its known falsity it is a mere “loose rumour” and thus neither relevant to the risk of the occurrence of an insured peril nor to the risk of moral hazard.⁹⁷ This is an attractive proposition but it is unsupported by the authorities, which suggest that (1) the insured’s own knowledge of innocence must be verifiable by exculpatory materials⁹⁸ and (2) wrong convictions may be material.⁹⁹

Adding to the complexities of assessing relevance, Waller LJ put forward for consideration a legal definition of moral hazard confined to facts related to the “risk of the insured destroying the insured subject-matter”.¹⁰⁰ It is submitted that such a definition may be both too narrow and too wide: it might exclude from the scope of disclosable moral hazards matters such as insolvency and unspent criminal convictions and it might still include unproven allegations of dishonesty because of their relevance to the risk of the insured fraudulently procuring the loss.

It is submitted that adopting a relevance qualification, whether to materiality generally or as part of a moral hazard definition which only allows for a binary outcome (i.e. relevant or not relevant), may not provide a just and comprehensive solution to unfounded allegation case. A better approach may be to regard relevance as a factor in a proportionate assessment of materiality, as discussed below.

b) Proportionality and Control of Expert Evidence

It will be recalled that in *Meisels*, Tugendhat J introduced the notion of proportionality when assessing the materiality of allegations:

“There is room for proportionality, having regard to the nature of the risk and the moral hazard under consideration. There may be things which are too old, or

⁹⁶ *Reynolds v Phoenix Assurance Co Ltd* (n 32), 459-460.

⁹⁷ SB Midwinter, ‘The Duty of Disclosure and Material Rumours’ [2003] LMCLQ 158, 162.

⁹⁸ *Brotherton* (n 28), para 18; *The North Star* (n 11), paras 17, 18, 35.

⁹⁹ *Brotherton* (n 28), para 23.

¹⁰⁰ *The North Star* (n 11), para 20.

insufficiently serious to require disclosure, whether or not there is exculpatory material.”¹⁰¹

In essence, proportionality requires that a number of factors, such as the seriousness, specificity, formality and likely veracity of an allegation and their relevance to the nature of the risk insured, are taken into account in determining the materiality of an allegation. The notion of proportionality is a step away from the idea of “equality of information”¹⁰² as it rules out from the scope of materiality allegations that are too remote to constitute moral hazard. Although proportionality was not explicitly referred to in *Brotherton* and *The North Star*, the categories of allegations considered to be immaterial or unlikely to be material by the Court of Appeal in both cases can be explained on the basis of proportionality: loose rumours lack specificity and by definition lack certainty as to the facts; old allegations would tend to lack in formality and veracity (as otherwise they would have been substantiated or repeated); trivial allegations lack seriousness; allegations not involving dishonesty could lack relevance; and allegations in relation to which the insured can provide exculpatory materials are likely to lack in veracity. In contrast, if criminal charges for a dishonesty offence have been laid against the insured by the relevant authorities on the basis of some evidence which has not been disproved by exculpatory materials at the time of the contract, it is arguable that the charge is material and should be disclosed. A proportionate approach is also supported by the authors of ‘Good Faith and Insurance Contracts’ who argue that the “seriousness and formality of the charge will assist in determining its materiality”.¹⁰³

How should “proportionality” be considered forensically? Tugendhat J held that the notion of proportionality can be accommodated in the “prudent underwriter test” and that it was for the courts to decide the characteristics to be imputed on the hypothetical prudent underwriter.¹⁰⁴ It is already accepted that the hypothetical prudent underwriter is rational, intelligent and reasonable¹⁰⁵ and these characteristics could be expanded to the effect that a prudent underwriter takes a proportionate approach as to the information that he allows to influence his underwriting judgment.

One objection that might be raised against a proportionality assessment is that, in any given allegation case, such an approach may not be supported by expert evidence of current underwriting practice. However, as the authors of MacGillivray have pointed out, current

¹⁰¹ *Meisels* (n 64), para 25.

¹⁰² *Brotherton* (n 28), see text to n 35.

¹⁰³ MacDonald Eggers, Picken and Foss (n 88), para 15.43.

¹⁰⁴ *Meisels* (n 64), para 25.

¹⁰⁵ *March Cabaret* (n 32) 176; *Associated Oil Carriers Ltd v Union Insurance Society of Canton Ltd* [1917] 2 KB 184, 191-192.

underwriting practices are not “the embodiment of the ‘prudent insurer’”.¹⁰⁶ It will also be recalled that in *Brotherton* Mance LJ said that the courts are “the ultimate decision-makers” on materiality issues and that they will be able to take a “realistic and even a robust view” on the materiality of allegations.¹⁰⁷ Moreover, Davey¹⁰⁸ and Gay¹⁰⁹ identified the court’s control over expert evidence in unfounded allegation cases as a key area for judicial intervention. Whilst it is conceded, as Waller LJ pointed out in *The North Star*, that judges will generally be reluctant to reject underwriter expert evidence¹¹⁰, such evidence is not conclusive¹¹¹ and courts are entitled to reach their own conclusions without the benefit of expert evidence on materiality.¹¹² Once proportionality is accepted as part of a prudent underwriter’s decision-making process in allegation cases, courts may be less reluctant to test more rigorously or override evidence that seeks to present the prudent underwriter as acting disproportionately in reaching an underwriting decision. In this respect, it should be noted that there have already been a number of cases in which expert evidence on materiality was rejected by the courts for being “extreme”, “arbitrary” or “unrealistic”.¹¹³

Another argument that could be raised against proportionality is that the notion introduces uncertainty as to which factors are to be taken into account and the weight they should be given. As Rix LJ noted in *Drake*, traditionally, proportionality has played a negligible part in English commercial law because it prefers “stricter and simpler tests for certainty”.¹¹⁴ Several points may be made in response: first, Rix LJ in *Drake* went on to acknowledge that it may be necessary to recognize a concept of proportionality “to give wider effect to the doctrine of good faith”.¹¹⁵ Whilst this was an obiter comment made in the context of limiting the insurer’s right to avoid, it shows a willingness to accept proportionality as a principle of insurance law. Secondly, the English courts are already applying principles of proportionality in a range of areas, for example when reviewing public acts or legislation for compatibility with the Convention for the Protection of Human Rights

¹⁰⁶ John Bird, Ben Lynch and Simon Milnes, *MacGillivray on Insurance Law* (12th edn, Sweet & Maxwell 2012), [17-044].

¹⁰⁷ *Brotherton* (n 28), para 28.

¹⁰⁸ Davey (n 60) 530-532.

¹⁰⁹ Robert Gay, ‘Non-disclosure and Avoidance: Lies, Damned Lies, and Intelligence’ [2004] LMCLQ 1, 4.

¹¹⁰ *The North Star* (n 11) para 19.

¹¹¹ *Brotherton* (n 28), para 28.

¹¹² *Synergy Health (UK) Ltd v CGU Insurance plc* (n 21).

¹¹³ e.g. see *Roselodge v Castle* [1966] 2 Lloyd’s Rep 113, 132, *Reynolds v Phoenix Assurance Co Ltd* (n 32), 459 and *The Dora* (n 12).

¹¹⁴ *Drake* (n 52), para 88.

¹¹⁵ *ibid*, para 89.

and Fundamental Freedoms¹¹⁶ or European Union law,¹¹⁷ as an aspect of “Wednesbury unreasonableness”¹¹⁸ in judicial review proceedings and in the context of the Civil Procedure Rules.¹¹⁹ Thirdly, every legal rule has to strike a balance between certainty of outcome on the one hand and flexibility and equity on the other. It is submitted that the current law on the duty of disclosure delivers neither on certainty, nor on equity: this article has noted the severity of the duty of disclosure and has shown how this might lead to injustice in unfounded allegation scenarios. At the same time, statistics¹²⁰ show a high volume of non-disclosure disputes, which is indicative of a lack of legal certainty, despite the seemingly simple test for materiality. Whilst proportionality may introduce a degree of uncertainty, the concept would be conducive to producing fairer results in allegation cases.

It is submitted that the principle of proportionality provides a rational basis for narrowing the range of material circumstances in allegation cases by reference to a number of factors indicative of the magnitude of moral hazard. In principle, proportionality could also operate to assess the materiality of other types of moral hazard or physical risks (using appropriate balancing factors) and, accordingly, could assist more generally in reshaping the width of the duty of disclosure.

c) Inducement

Davey suggests that the courts could narrow the test for inducement so that the remedy of avoidance will only be available if the insurer is genuinely prejudiced by the non-disclosure.¹²¹ Although the Court of Appeal in *Brotherton* rejected the proposition that the test for the disclosure of unfounded allegations focuses on the need for actual prejudice¹²², Davey reasons that there is room for manoeuvre for making changes to the inducement test because the concept has not yet been exhaustively examined by the courts and inducement is not one of the elements of non-disclosure referred to in the MIA 1906. Davey’s inducement test would operate with full hindsight, assessing whether the insurer would not have entered into the contract on the same terms if the full truth, including facts reducing the risk, had been

¹¹⁶ e.g. *AG's Reference (No 2 of 2001)* [2003] UKHL 68, [2004] 2 AC 72.

¹¹⁷ e.g. *R v Secretary of State for the Environment, ex p Oldham Metropolitan Borough Council* [1998] ICR 367

¹¹⁸ e.g. *R (on the application of Alconbury Developments Ltd) v Secretary of State for the Environment, Transport and the Regions* [2001] UKHL 23, [2003] 2 AC 295.

¹¹⁹ Civil Procedure Rules, Rule 1.1(2)(c).

¹²⁰ Law Commission (n 81), paras 37-44: The Law Commission found records of 41 reported judgments on MIA 1906 s 18 between 2002 and 2012 and estimated that the costs of disputes over non-disclosure in commercial insurance in England and Wales over 10 years are £464,000,000.

¹²¹ Davey (n 60) 532-533.

¹²² See text to n 34.

known. By comparison, in *Drake* the court was only prepared to consider the likely reaction of the actual insurer if disclosure had been made and following discussions between the parties. It is submitted that, whilst Davey's inducement test is an attractive solution which could strike a fairer balance between the insurer and the insured, in order to establish non-inducement, the insured would be allowed to litigate the veracity of the allegation on a purported avoidance. In *Brotherton*, Mance LJ stated, albeit in relation to the right to avoid, that litigating the veracity of an allegation would be undesirable as a matter of policy because it would force insurers to investigate the allegation's veracity and put them at risk of additional litigation and expenses.¹²³ Gay argues that it may be reasonable for the insurer only to plead the existence of the allegation and that it was not disclosed, and that it should then be for the insured to prove that the allegation was false.¹²⁴ It is submitted that the insurer would still be exposed to the trouble and expense of considering the evidence as to the veracity of the allegation as part of establishing its right to avoid and its trial preparations.

d) Avoidance

In *The North Star*, Waller LJ also put forward for reconsideration the idea that the insurer's right to avoid should not be absolute¹²⁵. In *Brotherton* the Court of Appeal rejected this idea (1) holding, by reference to the authorities on rescission in general contract law, that a court had no role to play in permitting or refusing the remedy of avoidance and (2) putting in considerable doubt that the insurer's exercise of the right to avoid is subject to a requirement of good faith.¹²⁶ As regards the first point, Clarke has criticised that there is an alternative line of authorities which supports the proposition that the courts have power to review the application of the self-help remedy of rescission and that the courts have discretion under the Misrepresentation Act 1967 to refuse rescission for misrepresentation.¹²⁷ If the courts would accept jurisdiction for the review of exercise of the remedy of avoidance, they could use their discretion to deny the remedy in cases where the insurer has acted unconscionably. However, it is submitted that this would introduce a level of uncertainty which would make it difficult for the insurer and the insured, as well as third parties such as reinsurers, to predict with some degree of confidence whether or not an election by the insurer to avoid will be confirmed or overturned by the courts. Moreover, if Mance LJ's analogy to the law on rescission in general

¹²³ *Brotherton* (n 28), paras 26, 29 and 31.

¹²⁴ Gay (n 109) 5-6.

¹²⁵ *The North Star* (n 11), para 20.

¹²⁶ See text to ns 43-46.

¹²⁷ Clarke (n 77) 558.

contract law is maintained, as Davey points out, proper consideration would need to be given to the potential impact on contract law generally.¹²⁸

As regards the imposition of good faith limits to the remedy of avoidance, in contrast to *Brotherton*, the majority of the Court of Appeal in *Drake* expressed the obiter view that, as a principle of fair dealing, the right of avoidance is fettered by the requirement to exercise it in good faith.¹²⁹ In support of this type of good faith argument, Merkin has shown that a continuing duty of good faith of the insurer has been held to apply in other instances, such in settlement negotiations with third parties in the field of liability insurance.¹³⁰ However, Mance LJ reasoned in *Brotherton* that the insured's continuing duty of good faith had been reduced by the courts¹³¹, thereby justifying a limited corresponding duty on insurers. As argued above, there is also a conceptual difficulty in the proposition that the doctrine of good faith can be both the basis for the remedy of avoidance and, at the same time, the basis for restrictions to the exercise of it. The editors of 'Arnould's Law of Marine Insurance and Average' have criticised that the *Drake* approach could leave the insurer without a remedy for the insured's breach of its disclosure obligations.¹³² In any event, Lowry and Rawlings have noted that, as a result of the decision in *Sprung v Royal Insurance (UK) Ltd*, the insured has no effective remedy for wrongful avoidance.¹³³ In light of these conceptual and practical difficulties with the imposition of good faith limits to the remedy of avoidance, it is submitted that a statutory reform introducing a compensatory remedies regime, as discussed below, might be a more promising option.

3. Legislative Change

Statutory legislative reforms can change the law more comprehensively but are difficult to achieve, as the proposals need to attract government support and the new law is required to pass through the parliamentary process. Following several failed attempts at legislative

¹²⁸ Davey (n 60) 535.

¹²⁹ See text to ns 57-58.

¹³⁰ Robert Merkin, 'Utmost good faith: Reliance on disproved facts', *Insurance Law Monthly* 1 July 2003; 'Reforming Insurance Law: Is there a Case for Reverse Transportation? Report for the English and Scottish Law Commissions on the Australian Experience of Insurance Law Reform' (published by the Law Commission), para 3.5.

¹³¹ See *Manifest Shipping Co Ltd v Uni-Polaris Shipping Co Ltd* [2001] UKHL 1, [2003] 1 AC 469; *Merc-Scandia XXXXII (K/S) v Lloyd's Underwriter* [2001] EWCA Civ 1275, [2001] 2 Lloyd's Rep 563 and *Agapitos v Agnew (No.1)* [2002] EWCA Civ 247; [2003] QB 556.

¹³² *Arnould's Insurance* (n 61), para 15-165.

¹³³ John Lowry and Philip Rawlings, 'Insurers, Claims & Boundaries of Good Faith' (2005) 68 MLR 82. If the insurer fails or refuses to pay an indemnity under the contract of insurance, the insurer will not be liable to the insured for any damage above the amount of the indemnity. This is because the indemnity is characterised by the law as damages and the courts will not award damages for the late payment of damages (see *Sprung v Royal Insurance (UK) Ltd* [1999] 1 Lloyd's Rep IR 111).

reform,¹³⁴ the 2012 Act replaces for consumer insureds the duty of disclosure with a duty to take reasonable care not to make misrepresentations to the insurer.¹³⁵ In relation to unfounded allegation scenarios, the effect of the 2012 Act is that consumer insureds will no longer be required to volunteer information on such allegations. Insurers are expected to ask questions and it is likely that they will be required to ask specific and clear questions about any allegations made.¹³⁶ It remains to be seen to what extent insurers will expand their proposal form questionnaires to include questions directed specifically at outstanding charges and allegations. In addition, the 2012 Act introduces for consumer insureds a compensatory remedies regime for careless misrepresentations: the insurer's remedy is based on what he would have done if the consumer had complied with its duty. Accordingly, the insurer's remedy might be avoidance if he would not have entered into the contract at all, but his remedy may be limited to the imposition of different terms or the charge of an additional premium.¹³⁷ The remedy for deliberate or reckless misrepresentations remains avoidance.¹³⁸

In relation to the business insured's duty of disclosure, the Law Commission's final report and a draft bill are due in summer 2014.¹³⁹ In its Joint Consultation Paper on the business insured's duty of disclosure¹⁴⁰ it has put forward proposals for statutory amendments to the MIA 1906 aiming at a "neutral" law that strikes a balance between the parties and which will impose reciprocal obligations on each".¹⁴¹ With the possible exception of the compensatory remedies regime, the proposals are no radical departure from the current law and build upon existing judicial inroads into the orthodox position and principles of good industry practice. Of course, the Law Commission's proposals are intended to apply across the whole spectrum of non-disclosures and misrepresentations and are not limited to allegation scenarios. This article, however, will limit itself to a more detailed consideration of those proposals that are most relevant to allegation cases.

¹³⁴ For a summary of the history of the reform process see John Lowry and Philip Rawlings, (n 5).

¹³⁵ 2012 Act s 2(2).

¹³⁶ This appears to be the effect of the 2012 Act, ss 3(2)(c) and 5(5)(b).

¹³⁷ 2012 Act, Schedule 1, ss 3-8.

¹³⁸ 2012 Act, Schedule 1, s 2. The insurer may also retain the premium unless to do so would be unfair to the consumer.

¹³⁹ At the time of writing, The Law Commission and The Scottish Law Commission has not published its Final Report on Business Insurance Law and its final draft of the Insurance Contracts Bill.

¹⁴⁰ Law Com CP 204 (n 8).

¹⁴¹ *ibid*, para 1.17.

a) Fair Presentation of the Risk

The Law Commission seeks to retain the duty of disclosure for business insureds as it is an established part of the way in which insurance business is done in the UK.¹⁴² Unlike the largely homogenous consumer market, the business insurance sector covers a wide variety of risks which are less amenable to being captured by questions in a proposal form. Instead, the Law Commission is proposing to redefine the notion of ‘material circumstance’ as a circumstance required to provide a fair presentation of the risk.¹⁴³ This includes the following categories of information: (1) any information which is special or unusual or relating to circumstances which increase the risk; (2) any particular concerns about the risk which led to the insurance being sought; and (3) standard information which market participants generally understand should be disclosed within a fair representation of risks of the type in question.¹⁴⁴ As this is not an exhaustive list, other circumstances such as unfounded allegations may still be material to provide a fair presentation of the risk. In any event, allegations may fall into categories (1) or (3).

Although there is no express reference to relevance or proportionality, it is arguable that these concepts pervade the materiality test proposed by the Law Commission. Categories (1) and (2) are examples of circumstances that are relevant to the risk. It is submitted that defining materiality not in terms of the prudent underwriter’s reaction, but as circumstances *required* to provide a *fair* presentation of the risk, imports implicitly a degree of proportionality. Thus, a “fair” presentation of the risk does not require a “minute disclosure of every circumstance” but simply needs to “enable a prudent underwriter to form a proper judgment on the risk”.¹⁴⁵ Moreover, the test focuses on the necessity (“required”) of the disclosure to reach the desired outcome of a fair presentation. It is noteworthy that this is a move away from the notion of “equality of information” which Mance LJ held to be the basis of a true and fair agreement for the transfer of risk.¹⁴⁶ Under the revised test, unfounded allegations, loose rumours, trivial and old allegations, allegations that do not raise issues of dishonesty and allegations in relation to which exculpatory materials exist at the time of the contract are likely to be immaterial. If the insurer requires a presentation of the risk that is

¹⁴² *ibid*, paras 4.7-4.8 and the DRAFT/Insurance Contracts Bill (draft Business Bill), s 3 (published by The Law Commission and The Scottish Law Commission on <http://lawcommission.justice.gov.uk/docs/draft_insurance_clauses_January2014.pdf>).

¹⁴³ Law Com CP 204 (n 8) para 5.78-5.79.

¹⁴⁴ *ibid*; draft Business Bill (n 142) s 4.

¹⁴⁵ *Garnat Trading & Shipping (Singapore) Pte Ltd v Baominh Insurance Corporation* [2010] EWHC Comm 2578, [2011] 1 Lloyd’s Rep 589 [135(d)].

¹⁴⁶ See text to n 36.

wider than “fair”, under the Law Commission’s proposals he will be expected to make further enquiries¹⁴⁷ or impose appropriate terms into the contract of insurance.

b) Insurer’s Knowledge

The Law Commission further proposes to amend the MIA 1906 to clarify the scope of the insurer’s knowledge, given that matters known or presumed to be known by the insurer need not be disclosed. They propose that the insurer’s knowledge comprises information known by the directing mind and will of the insurer, the persons making the underwriting decision and information held by the insurer’s agent or employees which ought to have been communicated to the person making the underwriting decision.¹⁴⁸ For example, in *Brotherton*¹⁴⁹, the media reports alleging misconduct and fraud by senior staff of the bank were common knowledge in Colombia. Had the reinsurer been a local insurer, the reinsurer might have been fixed with that knowledge. Moreover, if the Colombian company engaged by the reinsurer to carry out an audit of the physical security of the bank had held information on the alleged frauds (which they did not on the evidence), their knowledge would have been imputed to the reinsurer.¹⁵⁰

c) Remedies

The Law Commission shares the view that the remedy of avoidance can operate disproportionately as it tends to overcompensate insurers who, had full and accurate disclosure been made, would have simply charged a higher premium or imposed different terms. However, the Law Commission also acknowledges that the remedy of avoidance has a policing function in respect of fraudulent non-disclosure and misrepresentation. It has therefore recommended that the remedy of avoidance be retained where the insured has acted dishonestly.¹⁵¹ However, where the insured’s non-disclosure or misrepresentation has not been dishonest, the Law Commission proposes a compensatory system of remedies seeking to put the insurer into the position it would have been in had full and accurate information been provided: “(1) Where the insurer would have declined the risk altogether, the policy should be avoided, the claim refused and the premiums returned. (2) Where the insurer would have accepted the risk but included another contract term, the contract should be treated as if

¹⁴⁷ Law Com CP 204 (n 8), para 5.79.

¹⁴⁸ Law Com CP 204 (n 8), para 8.50.

¹⁴⁹ *Brotherton* (n 28).

¹⁵⁰ *ibid*, para 36.

¹⁵¹ Law Com CP 204 (n 8) para 9.76; draft Business Bill (n 142), s 7, Schedule, Part 1, s 2.

it included that term. (3) Where the insurer would have charged a greater premium, the claim should be reduced proportionately.”¹⁵²

It is noteworthy that the remedies regime proposed for business insureds is different to that for consumer insureds in the 2012 Act in two major respects: (1) it is envisaged to be a default regime that the parties are permitted to contract out of;¹⁵³ and (2) innocent non-disclosures and misrepresentations would fall within the proportionate remedies regime (whereas innocent misrepresentations by a consumer insured do not attract any remedy at all¹⁵⁴). The Law Commission noted concerns about the practicality of working out what an insurer would have done had he known the true facts but does not accept that this justifies the rejection of a fairer remedies regime,¹⁵⁵ in particular as the parties to the contract can agree to opt out of the default regime if they consider that it would be inappropriate in the circumstances.

A compensatory remedies regime may be helpful to an insured who non-fraudulently failed to disclose a material allegation. In many cases, a pre-contractual disclosure of a material allegation would have merely resulted in a higher premium or the imposition of terms in relation to the allegation. Whilst an increased premium might be unfair on an insured against whom an unfounded allegation has been raised, it is a comparatively small price to pay for continuing insurance coverage and the payment by the insurer of any valid claims. If the insurer would have imposed a term in relation to the relevant allegation, such a term may not even become operative in unfounded allegation scenarios. For example, where an allegation of fraud was made against a director of the insured, the insurer under a property and business interruption policy might have excluded from coverage any losses resulting from such fraud. If the allegation subsequently turns out to be unfounded, this exclusion will not become operative and therefore have no impact on coverage.

On the other hand, if the insurer asks the insured a specific question about allegations of dishonesty or criminal conduct but the insured, albeit aware of such an allegation, responds in the negative knowing the allegation to be unfounded, this may constitute a dishonest misrepresentation for which the remedy remains avoidance. However, it should be noted that the authorities are divided on whether an inquiry by the insurer has the effect of making

¹⁵² Law Com CP 204 (n 140) paras 9.39, 9.40]; draft Business Bill (n 142) s 7, Schedule, Part 1, ss 3-9.

¹⁵³ Law Com CP 204 (n 140) para 9.82]. It should be noted that, under the draft Business Bill (n142) s 17 , contracting-out would be subject to the ‘transparency provisions’ applying to ‘disadvantageous terms’.

¹⁵⁴ 2012 Act, s 4(1).

¹⁵⁵ Law Com CP 204 (n 140), para 9.3.

otherwise immaterial information material¹⁵⁶. Moreover, the courts are likely to expect an insurer to ask clear and specific questions and may construe any ambiguities *contra proferentem*. Overall, it is submitted that the remedies regime proposed by the Law Commission, if implemented into legislation, would be a significant step in redressing the balance between insurer and insured as, in the instance of non-fraudulent non-disclosures, it aims to be genuinely compensatory for the loss the insurer has suffered, if any, as result of the non-disclosure. It is a default regime that neither over-compensates the insurer nor penalises the honest insured and, in that sense, it is neutral and proportionate.¹⁵⁷ Accordingly, the number of cases in which insurers opportunistically seek out and rely on non-disclosures at the claims stage to avoid a bargain that no longer suits them, should diminish. Arguably, if avoidance is no longer the only available remedy, there will be less pressure on the courts to intervene in circumstances where the insurer purports to exercise the remedy other than in good faith.

E. CONCLUSION

Over 40 years ago, Hasson¹⁵⁸ advocated a recalibration of the pre-contractual duty of disclosure into a much narrower duty as originally conceived by Lord Mansfield in *Carter v Boehm*.¹⁵⁹ In allegation cases involving business insureds the orthodox position is that the duty of disclosure remains a wide one: regardless of their actual veracity, allegations may be material and therefore disclosable to the insurer. As has been shown, this can cause injustice to the insured because he may be put in a position where he must choose between (1) disclosing an unfounded allegation and risking paying a higher premium or being denied insurance, or (2) withholding disclosure and risking avoidance of the policy by the insurer. However, the more recent case law suggests that there is an emerging notion of proportionality in assessing the materiality of allegations. This article has argued that this is a welcome judicial inroad into the orthodox position which could be developed into a general principle of proportionality to provide a rational basis on which the range of circumstances material for pre-contractual disclosure can be narrowed down. It has been argued that a notion of proportionality can be accommodated in the “prudent underwriter test”, which underpins the concept of materiality: the hypothetical prudent underwriter would take a

¹⁵⁶ See *MacGillivray* (n 106) para 17-040; similarly, see *McNealy v Pennine Insurance* [1978] 2 Lloyd’s Rep 18, 20 (Denning LJ); in contradiction, see *Mutual Life Insurance v Ontario Metal Products* [1925] AC 344 (PC).

¹⁵⁷ Law Com CP 204 (n 140), para 9.33.

¹⁵⁸ Hasson (n 5).

¹⁵⁹ *Carter v Boehm* (n 1).

proportionate approach as to the information that he allows to influence his judgment. This article has also advocated that the courts should take a more confident approach to expert evidence on materiality.

The Law Commission's reform proposals also seek to rebalance the duty of disclosure, *inter alia* by narrowing the definition of materiality and by introducing a more flexible remedies regime applicable to non-fraudulent non-disclosures and misrepresentations. This article has argued that the proposals for a compensatory remedies regime would allow for fairer and more proportionate relief, such as the payment of an additional premium or the imposition of additional terms in appropriate circumstances and would make it harder for insurers to use the remedy of avoidance opportunistically. If the Law Commission's proposals are implemented in combination with the development of the judicial notion of proportionality, it should be possible to attain a fairer balance between protecting the insured from oppressively harsh disclosure obligations and providing the insurer with a fair presentation of the risk in unfounded allegation cases and in the placement of business insurance more generally. Striking a fair balance will assist in keeping the UK insurance market internationally competitive and in upholding the reputation of English law as fair and commercial.