"Good faith: To Be Or Not To Be"

From the speech given at the President's Lunch, 19 December 2001
by The Rt Hon Lord Justice Rix

Some of you may think that "To be or not to be" are the opening words of Hamlet's great soliloquy about the possibilities of suicide. But Hamlet's soliloquy also contains numerous reminders of the law, insurance and litigation, exactly what this Association is concerned with – I cite but a few of the references: "that is the question...a sea of troubles...the thousand natural shocks...the law's delay...the insolence of office...conscience" – perhaps an early reference to the doctrine of good faith – "the pale cast of thought...enterprises of great pith and moment" – and finally "the name of *action*".

Be that as it may, and you may or may not be convinced thus far, why really have I given my talk the title I have? Well, the basic reason is that it seems to me to express in a few words, usefully of one syllable, two divergent movements in the practice and law of insurance and reinsurance today.

On the one hand, ever since Banque Keyser[3] in the late 1980s, the courts have been asked to explore, almost for the first time since the duty of good faith was developed by Lord Mansfield in the eighteenth century, the question of that concept operating in the context not of the making of an insurance contract, but of the performance of it. So here is a field in which the boundaries of the concept of good faith are possibly being extended: or are they?

On the other hand, the courts are also being asked to come to grips in recent years with a number of insurance contracts where the parties have chosen to enter into exclusion clauses which, whatever their extent, and that is nearly always a matter of controversy sooner or later, are obviously designed to trespass a certain distance or further into the obligations involved in the concept of good faith, such as proper disclosure and the avoidance of misrepresentation. Not only that, but underwriters have shown themselves willing in recent years, it seems to me increasingly willing, to undertake in an insurance format business risks of a financial nature, such as

3 *Banque Keyser Ullman SA v. Skandia (UK) Insurance Co Ltd* [1990] 1 QB 665 (Steyn J and CA), *Banque Financière de la Cité SA (formerly Banque Keyser Ullman SA) v. Westgate Insurance Co Ltd (formerly Hodge General & Mercantile Co Ltd [1991] 2 AC 249 (HL).*

mortgage indemnity insurance[4] and film finance insurance[5], which see the underwriter undertaking not so much the risk of a fortuitous intervention, but the essential business risk of the assured himself. Thus in mortgage indemnity insurance, the underwriter undertakes the lender's risk that both his borrower and his security will be unable to repay the loan, and in film finance insurance the underwriter undertakes the risk that the film will be insufficiently successful to repay the basic costs of making it. Such risks, it seems to me, are in a business sense distinct from the more traditional risks of loss and damage to property or personal injury and death, to be met for instance in marine, aviation, property, motor and life insurance. In between these two divisions lie more traditional types of financial risk, such as liability insurance and fidelity insurance and business interruption insurance and even political risk insurance, where the risk is incidental to the assured's business, but is not the same as the essential core of the assured's business.

It is in just such new or newish types of business risk insurance as mortgage indemnity insurance and film finance insurance that one sees the good faith duty most under attack in the form of exclusion clauses of one kind or another. I do not think that that is a coincidence. As the underwriter steps closer to the essential business risk of his assured, so the assured seeks a contract in which the underwriter is asked to take that risk in purer form, without the protection of the duty of good faith. That in a sense is paradoxical, because it might be said that no assured knows more about his own risk, and no underwriter knows less about his assured's risk, than the parties to a business risk insurance of this kind. And yet it was just this consideration, that the insured knows much more about his own business than the underwriter can know, that led to the imposition of the duty of good faith and the need for disclosure in the first place. What is going on here? Do the lawyers know? Do the parties know? Are underwriters wise to undertake the basic business risk of their assured without knowing as much about it as their assured and without the protection of the duty of good faith? That is perhaps not a legal question, but it is a question.

4 See eg *Svenska Handelsbanken v. Sun Alliance and London Insurance plc* [1996] 1 Lloyd's Rep 519.

5 See eg *HIH Casualty & General Insurance Ltd v. New Hampshire Ins Co* [2001] 1 Lloyd's Rep 378 (David Steel J), [2001] 2 Lloyd's Rep 161 (CA) and *HIH Casualty & General Insurance Ltd v. Chase Manhattan Bank [2001] 1 Lloyd's Rep 30 (Aikens J)*, [2001] 2 Lloyd's Rep 483 (CA).

So whither the duty of good faith?

There is another consideration within the context of my question. Insurance law is familiar with the operation of the duty of good faith in the making of an insurance contract. Insurance law is becoming more familiar than it used to be about the problems of the operation of the duty of good faith in the *performance* of the insurance contract. But what about the operation of the duty of good faith in the *unmaking* of the insurance contract? When a breach occurs, be it of warranty or condition or of the duty of good faith itself, and the insurer says that he is free of his contract, or elects to avoid it, does he owe any duty of good faith to the assured in the exercise of his rights? This is a question which is sometimes asked in a general way, outside the particular context of insurance contracts, where it is well known that in English law, unlike the civil law, there is no all pervasive doctrine of good faith. But why has it never been asked in the specific context of insurance law, where there is even in England a concept of good faith, and it is recognised that that concept is mutual and survives the making of the contract itself?

So whither the duty of good faith?

It is intriguing in this context to go back to Lord Mansfield and the famous case of *Carter v. Boehm*[6] decided in 1766. This is often cited as the origin of the doctrine. The risk there insured might be described as the archetypal political risk, for it was against the loss of so-called Fort Marlborough, a trading settlement in India, to any European enemy within the year. It fell to a French naval force. The underwriter, facing a huge loss, pleaded...(what do you think?) yes, non-disclosure, to the effect that he was not informed of the insured's fears of a French attack and of the fort's inadequate protection, if attacked from the sea. The defence failed. Lord Mansfield regarded the insurer in London to be as well or better informed about the military situation as the governor of the fort, who was the assured. He regarded the insurer as waiving further enquiry. He said "The underwriter, here, knowing the governor to be acquainted with the state of the place; knowing that he apprehended danger, and must have some ground for his apprehension; being told nothing of either; signed this policy, without asking a question."[7]

Lord Mansfield regarded a defence of non-disclosure in such circumstances as itself capable of being an instrument of fraud, which it should never be allowed to be.

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[6] *Carter v. Boehm* (1766) 3 Burr 1905, 97 ER 1162.

[7] (1766) 3 Burr 1903 at 1918, 97 ER 1162 at 1169.

Thus this leading case on the duty of good faith resulted in a great victory for the assured, and a warning to underwriters not to attempt to misuse the doctrine.

I do not suppose that the facts of the case are very well known, however. What Carter v. Boehm is famous for are Lord Mansfield's dicta on the nature of the duty. He considered that it was "applicable to all contracts and dealings",[8] but in this attempt to introduce into the English common law the civil law doctrine of good faith, he failed. It only took root in English law in the insurance setting. In that setting, Lord Mansfield was not very clear as to whether non-disclosure could be innocent or required, if not necessarily fraud, at any rate a notion of concealment. He said that fraud was not necessary: for the suppression, as he called it, could occur through mistake, i.e. without an intention to deceive. But he seems to have had in mind that concealment was necessary at least in the sense of a deliberate intention to keep quiet about that which it was to your advantage that those, who had an interest in knowing, should be ignorant of. As he said in the now forbidden Latin: "aliud est celare; aliud tacere"[9] – it is one thing to conceal, another to be silent.

Thus it was that for many years, as the doctrine was worked out, the law spoke not so much of non-disclosure, which is the modern word, but of concealment. It was only by stages that the inconsistency or ambiguity in Lord Mansfield's doctrine was refined into the doctrine which has come down to modern times, that a non-disclosure may be completely innocent and unintentional, and yet effective to permit the remedy of avoidance. The breach of the duty, in other words, depends not so much on the motive of the assured, as on the content of the non-disclosure.

As such, the doctrine is an effective instrument to protect the insurer against his ignorance of that which he needs to know, but it has strayed quite far from its origin in a doctrine of good faith. In this modern sense, good faith has become a somewhat conventional concept.

It is perhaps for this very reason that there has been in more recent times a swing of the pendulum towards incorporating exceptions to the operation of the duty of disclosure. This has occurred not only in the pure business risk context of which I was speaking earlier, but also, as I understand, in the context of consumer insurance contracts where either special terms or even statements of practice seek to render the duty of good faith relevant only if broken fraudulently or negligently.

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[8] (1766) 3 Burr 1905 at 1910, 97 ER 1162 at 1164.

[9] (1766) 3 Burr 1905 at 1910, 97 ER 1162 at 1164.

Similarly, in *Pan Atlantic Insurance v. Pine Top Insurance*[10] in 1994 the House of Lords charted a new course in holding that, for a breach of the duty of good faith in making an insurance contract to be effective, it had to have induced the making of the contract. That decision required the need for inducement to be implied into the Marine Insurance Act. In coming to that conclusion, in one of the most important insurance judgments in recent years, Lord Mustill said this:[11]

> *"The existing rules, coupled with the presumption of inducement, are already stern enough, and to enable an underwriter to escape liability when he has suffered no harm would be positively unjust, and contrary to the spirit of mutual good faith recognised by s 17, the more so since non-disclosure will in a substantial proportion of cases be the result of an innocent mistake."*

I think there is a similar modern awakening to the underlying doctrine of good faith, and not to a merely conventional view of the duty, in the series of cases in recent times about the operation of the mutual duty of good faith after the making of an insurance contract and in the performance of it. Those cases have for the moment culminated in *The Star Sea*[12] in the House of Lords and even more recently in *Merc-Scandia*[11] in the Court of Appeal. In *The Star Sea*[10] it was held that only fraud in the claims context will entitle the insurer to avoid the contract; and in *Merc-Scandia*[13] it was held that even fraud in the claims context will not entitle avoidance unless the fraud was so material as to amount to a repudiation of the contract as a whole. The latter decision, like *Pan Atlantic*[8], appears to proceed on the basis of an implied limitation on the statutory right of avoidance.

What one sees here is, I think, the realisation that a proper doctrine of good faith requires remedies for breach to become more thoughtful, focused, proportionate and flexible. In one sense, this may all be a reaction to the *Banque Keyser*[1] case which says in effect: good faith is a rule of law, not an implied term, and therefore does not sound in damages only in avoidance. That may have been all very well in the context

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[10] *Pan Atlantic Insurance Co Ltd v. Pine Top Insurance Co Ltd* [1995] 1 AC 501.

[11] at 549D.

[12] *Manifest Shipping Co Ltd v. Uni-Polaris Shipping Co Ltd (The Star Sea)* [2001] 2 WLR 170.

[13] *K/S Merc-Scandia XXXXII v. Lloyd's Underwriters* [2001] EWCA CIV 1275.

of good faith in the making of a contract, but it does not work very well in the context of the *performance* of a contract. Since then, the following has occurred:

- it has been realised that the post-contractual situation is not the same as the pre-contractual situation;
- it has been decided (in the Star Sea)[10] that, at any rate in the claims' context, post-contract, there is no breach which entitles avoidance unless there has been material fraud (two limitations);
- it has also been decided (*ibid*) that the post-contractual duty of good faith ends with litigation and is superseded by its rules; (a third limitation);
- because the post-contractual duty of good faith in the claims context overlaps with either express or implied terms dealing with the prohibition and consequences of fraudulent claims, and also because the remedy of avoidance ab initio is such a draconian and disproportionate remedy, therefore it should be limited to a situation where the breach is repudiatory (*Merc-Skandia*[11], a fourth limitation);
- Lord Scott in *The Star Sea*[10] has gone so far as to suggest that breach of the duty of good faith actually requires "bad faith". Where does that take you, unless he was speaking solely in the post-contractual context?

And so I go on to raise the question of what the mutual requirement of good faith may require in the context of the unmaking of a contract. To some extent, recent cases in the post-contractual context may be said to be already knocking, questioningly, at this door. I grant that breaches of the obligation of good faith in the pre-contractual and post-contractual periods raise different problems, for the former, unlike true examples of the latter, impeach the making of the contract itself. Nevertheless, perhaps we should not be afraid, in the name of good faith, to be thinking hard about the mighty remedy of avoidance ab initio and the circumstances in which it is fair and appropriate for it to be used. As we have seen, in the form of exclusions or statements of practice, the industry has to some extent been moulding its own solutions. Recent cases which I have highlighted, particularly in the context of post-contractual breaches, teach the lesson that considerations of remedies for breach are critical to the soundness of the doctrine, and that if we were starting all over again, we would not have at any rate a post-contractual duty of good faith which sounds in avoidance ab initio. The trouble with that remedy of course, is that not only does a breach of good faith in relation to one claim imperil not only that claim but the whole policy, but the danger to the whole policy raises the problem of

unscrambling all that has happened under the policy ab initio: the cover itself from its inception and all payments, not only of premium but for instance of other claims, that may already have occurred under the policy.

Warranties and their effect, although not themselves founded in the doctrine of good faith, raise an analogous problem. Any breach of warranty, unless the insurer waives it, puts an end to the contract's existence, although in this case, the contract dies from the moment of breach rather than ab initio. The unsatisfactory nature of this rule in cases where the breach is causally irrelevant to a loss has long been recognised, and other jurisdictions have found a means to overcome this problem.[15] In English law it remains, although the Law Commission has I think recommended its reform. I quite understand the logic of the rule, which is that since a warranty is part of the definition of the risk, any breach of it renders the insurer entitled to say that "This is not the cover which I agreed to give" and so to stand aside.[16] But experience has shown that this logic can lead to unfairness. It is intriguing that, as far as I am aware (but I have conducted no specific research into the question), the common law has not sought to marry up the competing logics of the insurance warranty and the concept of good faith. It might be said that the latter concept would place some limits on the exercise of the power to found the destruction of the policy on a causally irrelevant breach of warranty. If English law had followed Lord Mansfield's desire to introduce the civil law concept of good faith generally into our law of contract, it may be that this issue would have emerged in our jurisprudence. As it is, the warranty doctrine is now so well entrenched not only in our common law but also in the Marine Insurance Act itself, that it is probably impervious to any assault that good faith could make on it.

Nevertheless, in my view the common law should not be afraid of moulding its own remedies, where at any rate statute gives it room to do so. The common law's ability to mould a proper, principled, response to individual circumstances is part of its genius. It should not be frightened of its strengths: *Pan Atlantic*[8], *The Star Sea*[10], *Merc-Scandia*[11] are all examples where the common law has found room for

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[14] [2001] 2 WLR 170 at 207G.

[15] See eg, in the US, *Home Insurance Co v. Ciconett* 179 F 2d 892 (1950), *Coffey v. Indiana Lumberman's Mutual Insurance Co* 372 F 2d 646 (1967).

[16] *See Bank of Nova Scotia v. Hellenic Mutual War Risks Association (Bermuda) Ltd (The Good Luck)* [1992] 1 AC 233 (HL).

improvement. Perhaps the most famous of all examples of this creativity in the field of remedies is *Hongkong Fir*[17] itself, albeit that lies outside the field of insurance law. Nevertheless it was concerned with the problem of a supposed doctrine which said that all remedies for breach of contract fell either into the camp of damages only (for breach of warranty) or into the camp of giving to the innocent party the option of terminating the contract (for breach of condition). Not so, of course, says *Hongkong Fir*[15]: for most terms are innominate, and the remedies for any breach of them depends on all the circumstances.

So whither good faith? To be or not to be? Will the genius of the common law struggle to solve these problems? Or is history or statute too strong? Do we need to look again at some of these problems, as Australia is in the course of doing, with an Australian Law Reform Commission report followed by recommended drafting changes to their existing Marine Insurance Act 1909?

While you consider the prospect of those slings and arrows of outrageous fortune, let me leave you with my favourite legal anecdote about the delicious nature of a knotty legal problem. I am indebted to a book in my library called "The Jottings of an old Solicitor", by Sir John Hollams, published in – 1906, a good vintage for insurance lawyers. Sir John tells this anecdote about Lord Bramwell at p 155 of his book:

> *"Many years before he was a judge, I had sent him a case for his opinion. He said to me some time after he had the case: "You must think I take a long time sending you that opinion. The fact is, I have written two opinions, one in your favour and the other against you. I read them both every morning, and cannot make up my mind which to send you." I expressed regret that it gave him so much trouble; he replied that it was a real pleasure to him."*

The Rt Hon Lord Justice Rix

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[17] *Hongkong Fir Shipping Co Ltd v. Kawasaki Kisen Kaisha Ltd* [1962] 2 QB 26 (CA).