

# WHAT DOES THE DUTY OF UTMOST GOOD FAITH (UBERRIMAE FIDEI) IN INSURANCE CONTRACT MEAN FOR THE CONSTRUCTION INDUSTRY?

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This article aims to understand what does the duty of utmost good faith (uberrimae fidei) in insurance contract mean for the construction industry. In construction insurance contracts, the duty of utmost good faith (uberrimae fidei) plays an important role. The analysis of case law shows that an insurer has the right in law to avoid the contract of insurance in its entirety if the insured was guilty of fraud, non-disclosure or misrepresentation before the contract was entered into. It seems to be unjust because even though the insured may be honest, he could still be in breach of duty. Utmost here means that both the insurer and the insured have the duty beyond the reasonable integrity and honesty. Furthermore, the insurer may also have a claim in the case of a breach of utmost good faith during the contract. It proceeds on the basis that the insurer likewise owes the insured a duty of good faith. While sounding good in theory, it can be argued that it may mean very little in practice. In the last decade, the English courts are turning their eyes towards the mutuality of the duty of good faith owed by the insurers to the insured. There is a new practical focus in the construction industry on inducement to balance the risk on the insured and insurer, where the mutuality of the duty of good faith is shifting towards the obligations on the insurers.

Keywords: construction law, insurance contract, uberrimae fidei.

## INTRODUCTION

In construction insurance contracts, the duty of utmost good faith (uberrimae fidei) plays an important role. The analysis of case law shows that an insurer has the right in law to avoid the contract of insurance in its entirety if the insured was guilty of fraud, non-disclosure or misrepresentation before the contract was entered into. It can be argued that even though the insured may be honest, he could still be in breach of duty. “Utmost” here means that both the insurer and the insured have the duty beyond the reasonable integrity and honesty. Furthermore, the insurer may also have a claim in the case of a breach of utmost good faith during the contract. It proceeds on the basis that the insurer likewise owes the insured a duty of good faith. While sounding good in theory, it can be argued that it may mean very little in practice.

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In common law, at the pre-contractual stage, each party has obligations to refrain from misinterpreting material facts and in principle, to disclose material facts even there is no questions asked. However, in commercial construction insurance contract, it is an obligation for the parties' caveat emptor not to misinterpret facts, but the parties are not obliged to disclose anything which is not asked. Over the years, the English courts debate on the concept of materiality and the duty of utmost good faith concerning the duty of disclosure and non-fraudulent misrepresentation. Lord Mansfield in *Carter v Boehm*<sup>2</sup> explained that the insured had the knowledge in assessing the risk:

*"The special effects by which the contingent chance is to be computed, lie most commonly in the knowledge of the insured only: the underwriter trusts to his representation and proceeds upon confidence that he does not keep back any circumstance in his knowledge, to mislead the underwriter into a belief that the circumstance does not exist, and to induce him to estimate the risk, as if it did not exist..."*

Lord Mansfield in *Carter v Boehm* also recognised the duty of utmost good faith is also reciprocal:

*"Good faith forbids either party by concealing what he privately knows to draw the other into a bargain from his ignorance of the fact, and his believing the contrary."*

## **AVOIDANCE**

Section 17 of the Marine Insurance Act 1906 indicates that the contract can be avoided by the other party if the utmost good faith has not been observed by either party. Section 17 is, in general, accepted to be equally valid for non-marine insurance contracts such as construction insurance contracts.

For an insurance contract in the construction industry, an insurer has the right in law to avoid the contract of insurance in its entirety if the insured was guilty of fraud, non-disclosure or misrepresentation before the contract was entered into. To avoid the contract means that the insurance policy would be treated as if it had never existed, or come into effect. Hence, the policy is void ab initio regardless of whether the breach was fraudulent, negligent or entirely innocent. Avoidance involves restitution, that is, the parties' position must be restored back to that prior to the contract: the claims paid to the insured should be refunded to the insurers; and the premiums had also to be returned to the insureds by the insurers.

## **FRAUD**

If the insured make a false statement and he knows that it is untrue, he is guilty of fraudulent misrepresentation. He is also guilty of fraudulent non-disclosure if he conceals any material fact wilfully from the insurers. This may also lead to damages claimed under tort because of the insured's deceitfulness. There may be a possibility for the insurers to keep the premium as decided in *Chapman*<sup>3</sup>. However, it is unenforceable to introduce a clause to protect an insured from fraud in a construction

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<sup>2</sup> (1766) 3 Burr. 1905, 97 ER 1162

<sup>3</sup> *Chapman and others, assignees of Kennet v Fraser* B R Trin. 33 Geo 111

insurance contract. In *Chase Manhattan*<sup>4</sup>, the House of Lord did not commit clearly whether a clause could protect the insured from dishonest misrepresentation or non-disclosure by his agent<sup>5</sup>.

## **NON-DISCLOSURE OR MISREPRESENTATION**

“*Non-disclosure*” is when a party has failed to disclose something which was not the subject of a question but which was known to them, which they ought to have considered it as material. As for a representation, it is something directly said in answer to a specific question.

The distinction between non-disclosure and misrepresentation can be found in the *Zurich General Accident* case<sup>6</sup>. Avoidance for non-disclosure will be restricted to facts of which the proposer was aware and which they ought to have realised the insurer would regard as material. Whereas the misrepresentation of a material fact will afford grounds for avoidance of the construction insurance contract no matter the proposer was aware that it was correct or not.

In common law, the potential parties are under an obligation not to misrepresent material facts which affect the insurer’s decision to accept the risk or not. In principle this is a reciprocal obligation, however it is obviously more in the burden of the insured than the insurer. It can be realised in section 20(1) of the Marine Insurance Act 1906 which deals only with the obligation of the proposer. Furthermore, section 18(1) of the Marine Insurance Act 1906 required the assured to disclose to the insurer every material circumstance which is known to the assured, before the contract is concluded. Section 18(1) allows the insurers to avoid the contract if the insured fails to make disclosure concerning every circumstance in the ordinary course of business.

## **TEST OF MATERIALITY**

Concerning the test of materiality, section 18(2) and section 20(2) of the Marine Insurance Act 1906 state that every circumstance which is material and would influence the judgment of a prudent insurer in fixing the premium, or determining any risk has to be disclosed with no misrepresentation. The theory in section 20(2) of the Marine Insurance Act 1906 had been interpreted more clearly in practice in the landmark case of *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd*<sup>7</sup>. The House of Lords held that “*a material circumstance is one that would have an effect on the mind of the prudent insurer in assessing the risk and it is not necessary that it would have a decisive effect on the insurer’s acceptance of the risk or on the amount of premium charged. Before an insurer may avoid a contract for misrepresentation of a material circumstance it has to show that it was induced by the misrepresentation to enter into the policy on the relevant terms.*” Pan Atlantic shows practically that the insurer owes the insured a duty of good faith.

In *Cuthbertson v Friends’ Provident Life Office*<sup>8</sup> concerning about critical illness cover, Lord Eassie observed that for a fact to be material, it has to be considered

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<sup>4</sup> HIH Casualty & General Ins Ltd v Chase Manhattan Bank [2003] UKHL 6, [2003] Lloyds Rep. I. R. 230

<sup>5</sup> J Birds and N J Hird, *Birds’ Modern Insurance Law* (8 th ed 2011) Sweet and Maxwell (p.114)

<sup>6</sup> *Zurich General Accident and Liability Insurance Co v Leven* 1940 SC 406, 415, by Lord President Normand

<sup>7</sup> *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* [1995] AC 501, 518, by Lord Mustill

<sup>8</sup> [2006] CSOH 74; 2006 SLT 567

material *cadit quaestio*<sup>9</sup> in the view of a reasonable underwriter. In practical terms, the insurer must also show that either “*the proposer appreciated that the fact in question would have had that significance*”, or, assuming that the proposer did not have that appreciation, or “*A reasonable person making the proposal and possessed with the factual knowledge possessed by the actual proposer would think that fact to be material to the insurer*”. This shows practically that the insurer owes the insured a duty of good faith.

In current practice in the construction industry in the United Kingdom, the person who is seeking insurance named as the proposer may normally complete a proposal form demanded by his broker. Although the proposer may simply answer specific questions appeared in the proposal form, his duty to disclose all material circumstances known, or deemed to be known, to them has not been removed<sup>10</sup>.

Section 17 of the Marine Insurance Act 1906 allows the Insurers the remedy of avoidance of the policy if the Insured breaches their duty of utmost good faith. Insurers are not allowed to seek damages for the breach relating to non-disclosure. They cannot deny liability for specific claim. They can only avoid the policy or to affirm it, waiving the breach and treating the policy as continuing.

## INDUCEMENT

In addition to the materiality test, insurer will only be entitled to avoid a policy if they can show that they were induced by the non-disclosure or misrepresentation by the insured, to enter the contract. In *St Paul v McConnell Dowell*<sup>11</sup>, four insurers of a construction project had avoided the contractor’s policy for all risks cover because the insurers were mal-informed that the Marshall Islands Parliament Buildings were to be built on piled foundations, but the design had changed to spread foundation. The proposer omitted disclosure of the changes to the insurers. There was a major subsidence of the buildings. The Court of Appeal ruled that the insurers were entitled to avoid the policy for reason of non-disclosure and misrepresentation even though the court accepted that the misrepresentation is an “*error in presentation*” and considered it to be a mistake “*in good faith*”. The court considered a few implications concerning the piled foundations. Firstly, the contractor had consulted and accepted professional advice; secondly, the ground conditions require more expensively deep piled foundations. The court decided that if the facts were disclosed, any prudent insurer would have a much higher estimate on risk and may come to a different decision on acceptance of the risk. It can be argued that the insurers had been induced by the non-disclosure to enter into the contract<sup>12</sup>.

The three underwriters argued that if the foundation design was disclosed, they would have been acted in a different manner. However, the Court of Appeal decided that there was consistent evidence from the three insurers, with expert evidence, but inadequate evidence to displace a presumption that the fourth insurer’s underwriter was induced in the same way as the other three underwriters by the non-disclosure or misrepresentation of the piled foundation. This is how the theory of the duty of utmost good faith works in practice in a construction context.

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<sup>9</sup> the fact is sufficient to settle the matter

<sup>10</sup> Section 18 of Marine Insurance Act 1906

<sup>11</sup> *St Paul Fire and Marine Co (UK) Ltd v McConnell Dowell Constructors Ltd* [1995] 2 Lloyd’s Rep 116

<sup>12</sup> “Insurance Law for the Construction Industry” Edited by Robert Hogarth, Oxford University Press (2008)

In practice, it can be argued that the inducement requirement has little effect on the “*decisive influence*” test as most insurers are prudent. If a fact is material it is not easy to envisage in what circumstances the insurer would not be induced by the insured’s failure to disclose the facts unless the insurer has acted imprudently for commercial purposes. A distinctive example demonstrating the insurers had not been induced by the failure to disclose material facts is the case of *Norwich Union Insurance Ltd. v Meisels*<sup>13</sup>. The court was convinced that the insurer had not been induced by the failure to disclose his circumstances because the insurer had deliberately omitted a question concerning insolvencies. Under this circumstance, the insurer could not argue that the insured had failed to disclose the information if the question was remained in the proposal form.

Whilst the insurer may have a claim in the case of a breach of utmost good faith in non-disclosure, the insurer also owes the insured a duty of good faith. In actual fact, they owe a mutual obligation to treat each other fairly. In practice, the insurer’s duty of good faith exists at all stages of the claims process. The insurer should act in a timely and considerate manner. They should not threaten the insured by their financial power.

## **MISREPRESENTATION**

Section 20 of the Marine Insurance Act 1906 requires a duty to ensure that all material representations made are true. In principle, representation can be oral or in writing, may be as to a matter of fact, or to a matter of expectation or belief. A matter of fact deemed to be true if it is “*substantially correct*”, and what a matter of expectation or belief deemed to be true if it is made “*in good faith*” that is “*honesty*”. It can be argued that there must be some basis to confirm a representation of expectation or belief to be considered that it is made in good faith<sup>14</sup>. While sounding good in theory, but in practice, it is very difficult to distinguish between a representation as to fact as to representation as to expectation or belief. This distinction is crucial as each case is different; hence the standard for determining it to be a misrepresentation is also dissimilar.

## **INFLUENCE**

It is not uncommon in the construction industry to employ a broker for the purpose of insurance contracts. A broker is considered to be the insured’s agent as identified by Purchas LJ in *Roberts v Plaisted*<sup>15</sup>. If the proposer discloses all material circumstances to his broker, he will still be liable if his broker fails to disclose them to the insurers. If the broker altered the data in the proposal form during the transference from the information given by the insured, the insured is still liable for the inaccuracy of the data. In practice, the breach of utmost good faith in this context can be seen in *Mark Whitlam v Andrew Hazel*<sup>16</sup>, the Court of Appeal ruled that the insurers were entitled to avoid the policy because the answers provided by the broker as the insureds’ agent in three questions concerning the insured’s occupation, were considered “*inaccurate and misleading*”.

For the insured, there are some exceptions to duty of disclosure. It can be argued that the insured does not need to disclose facts which reduce risk, or facts the insurers

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<sup>13</sup> [2006] EWHC 2811; [2007] 1 Lloyd’s Rep IR 69 (QBD)

<sup>14</sup> *Economides v Commercial Assurance Co Plc* [1998] QB 587 (QBD)

<sup>15</sup> [1989] 2 Lloyd’s Rep 341 (CA)

<sup>16</sup> *Mark Whitlam v Andrew Hazel for Lloyds Syndicate 260 trading as K6M Motor Policies at Lloyds*

should know or presumed to know, or facts which are of common knowledge and also facts that the insurer has waived disclosure.

## REMEDIES

As discussed earlier, the only remedy in practice for misrepresentation under the Marine Insurance Act 1906 is avoidance. An insurer can avoid the contract no matter the misrepresentation was entirely innocent, fraudulent or negligent. In practice, there are also some other implications.

Firstly, an insurer may reject any claim that has been made, and recover any claims payments already made.

Secondly, the policyholder may demand the return of the premium paid. An exception to this in terms of fraudulent misrepresentation is stated in section 84(3)(a) of the Marine Insurance Act 1906: “*Where the policy is void, or is avoided by the insurer as from the commencement of the risk, the premium is returnable, provided that there has been no fraud or illegality on the part of the assured*”.

Sections 17, 18 and 19 of the Marine Insurance Act 1906 indicate that the contract can be avoided by the other party if the utmost good faith has not been observed by either party. This remedy is draconian to the insured as they are deprived from any cover no matter they made an innocent mistake or a wilful concealment. In practice, the Courts had made damages available as illustrated in cases of *Banque Keyser v Skandia*<sup>17</sup> and *The Good Luck*<sup>18</sup>.

In practice, a breach of the duty of good faith does not automatically give a right to damages. Steyn J, in *Banque Keyser v Skandia*<sup>19</sup> suggested that once it is accepted that the principle of the utmost good faith imposes meaningful reciprocal duties, owed to the insurers and vice versa, it seems anomalous that there should be no claim for damages for breach of those duties in a case where that is the only remedy. However, the Court of Appeal had a different opinion; damages were rejected because they have not been mentioned in the Marine Insurance Act 1906. It can be argued that the Courts decided that non-disclosure does not give rise to liability in damages, because deceit or fraud requires a positive misrepresentation whereas non-disclosure is not.

Birds<sup>20</sup> commented that in *Fraser v Thames Television*<sup>21</sup>, the court has been prepared to create new torts. His arguments against a new tort were:

Firstly, the duty of disclosure arises from the common law courts of Lord Mansfield, and not equity as suggested by the Court of Appeal.

Secondly, while the court suggested the effect on the actual underwriter in question was irrelevant, *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co*<sup>22</sup> means this point no longer stands.

Thirdly, the absence of a reference to damages in section 17 should not be decisive as the 1906 Act was a codification of common law. In other circumstances the courts have been content to accept implied meanings of the Act. Finally, the fact that fault is

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<sup>17</sup> *Banque Keyser v Skandia* 1987, 1 Lloyd’s Rep 69

<sup>18</sup> *Bank of Nova Scotia v Hellenic Mutual War Risks Association (Bermuda) (“The Good Luck”)* 1989, 2 Lloyd’s Rep 238

<sup>19</sup> *Banque Keyser v Skandia* 1987, 1 Lloyd’s Rep 69

<sup>20</sup> J Birds and N J Hird, *Birds’ Modern Insurance Law* (8 th ed 2011) Sweet and Maxwell

<sup>21</sup> *Fraser v Thames Television* [1984] QB 44; [1983] 2 All ER 101

<sup>22</sup> [1995] 1 AC 501

not needed for a breach should also not be decisive this means a party in breach of contract, can be liable without fault or blameworthiness.

It can be argued that the wording of “*if utmost good faith is not observed by either party, the contract may be avoided by the other party*” in section 17 should be repealed<sup>23</sup>. The law should allow the court to decide appropriate remedies. If the insurer acts in bad faith, damages should be available to the insured.

## **CONCLUSIONS**

In conclusion, the duty of utmost good faith (*uberrimae fidei*), indeed, plays an important role in construction insurance contracts. What does the duty of utmost good faith (*uberrimae fidei*) in insurance contract mean for the construction industry? An insurer has the right in law to avoid the contract of insurance in its entirety if the insured was guilty of fraud, non-disclosure or misrepresentation before the contract was entered into. It seems to be unjust because even though the insured may be honest, he could still be in breach of duty. The insurer may also have a claim in the case of a breach of utmost good faith during the contract. It proceeds on the basis that the insurer owes the insured a duty of good faith. In the last decade, the English courts are turning their eyes towards the mutuality of the duty of good faith owed by the insurers to the insured. There is a new practical focus on inducement to balance the risk on the insured and insurer, where the mutuality of the duty of good faith is shifting towards the obligations on the insurers.

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