

**A Research to Develop English Insurance Law to Accommodate  
Islamic Principles**

**A thesis submitted to The University of Manchester for the degree of  
Doctor of Philosophy (PhD) in the Faculty of Humanities**

**2012**

**MAHFUZ**

**SCHOOL OF LAW**

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Consumer Contracts Regulations 1999

Financial Services and Markets Act 2000

Gambling Act 1845

Gambling Act 2005

ICOBS Rules

Insurance Companies Regulations 1994

Insurance Contracts Act 1984

Life Assurance Act 1774

Malaysia Takaful Act 1984

Marine Insurance Act 1906

Marine Insurance Act 1745

Proceeds of Crime Act 2002

Rehabilitation of Offenders Act 1974

Suicide Act 1961

Takaful Act 1984

The Insurance Act 1996

The Unfair Terms in Consumer Contracts Regulations 1999



## List of Abbreviations

ABLR.....	Australian Business Law Review
ABR.....	Australia Bar Review
AC.....	Appeal Cases
ALA. L. Rev.....	Alabama Law Review
All ER.....	All England Law Reports
ALJR.....	Australian Law Journal Reports
ALQ.....	Arab Law Quarterly
ALR.....	Australian Law Reports
Alta LR.....	Alberta Law Review
Anglo-Am LR.....	Anglo-American Law Review
APLR.....	Asia Pacific Law Review
BLR.....	Bond Law Review
Brit J Criminol.....	British Journal of Criminology
Ch D.....	Law Reports, Chancery
CJIL.....	Canadian Journal of Insurance Law
CLJ.....	Cambridge Law Journal
Colum. L. Rev.....	Columbia Law Review
DCJ.....	Defense Counsel Journal
Drake L. Rev.....	Drake Law Review
EIB.....	Encyclopaedia of Islamic Banking
ER.....	English Reports
EWCA Civ.....	Courts of Appeal (Civil Division) England & Wales)
EWHC.....	High Court (Chancery Division) (England & Wales)
Exch.....	Exchequer Reports
ICLQ.....	International & Comparative Law Quarterly
IILR.....	International Insurance Law Review

IJBL.....	International Journal of Baltic Law
ILJ.....	Insurance Law Journal
ILM.....	Insurance Law Monthly
I.R.L.N.....	Insurance and Reinsurance Law Newsletter
IRP.....	ISRA Research Paper
JBL.....	Journal of Business Law
JIBFL.....	Journal of International Banking and Financial Law
JMLC.....	Journal of Maritime Law and Commerce
J.S. Afr. L.....	Journal of South African Law
KB.....	Law Reports, Kings Bench
Ky. LJ.....	Kentucky Law Journal
LMCLQ.....	Lloyd's Maritime and Commercial Law Quarterly
LQR.....	Law Quarterly Review
MLR.....	Modern Law Review
NLJ.....	New Law Journal
NSWLR.....	New South Wales Law Reports
NZLR.....	New Zealand Law Reports
OHLJ.....	Osgoode Hall Law Journal
Q.B.....	Law Reports, Queen's Bench
RLR.....	Religion and Law Review
SA Merc LJ.....	South African Mercantile Law Journal
Sing J Legal Stud.....	Singapore Journal of Legal Studies
Tort & Ins LJ.....	Tort & Insurance Law Journal
TTIPLJ.....	Tort Trial & Insurance Practice Law Journal
Tul LR.....	Tulane Law Review
YLJ.....	Yale Law Journal
UBCLR.....	University of British Columbia Law Review

UMich.J.L.R.....University of Michigan Journal of Law Reform  
Willamette LJ.....Willamette Law Journal  
WLR.....Weekly Law Reports

## **ABSTRACT**

In recent years the popularity of Islamic insurance policies has grown rapidly with many companies across the world providing this service. London is said to be the hub for Islamic finance. It is well known for welcoming innovative financial methods. The FSA have already authorised the insurance company Salaam Halal to provide policies based on Shariah principles. The FSA, however, announced that they must operate within the same legal framework as all other insurance policies. Consequently English law has to be applied in Islamic policies taken in this country. However, in many aspects, Shariah principles contradict English insurance law. This thesis aims to discover how they contradict and recommend how the Islamic insurance policies can be applied in English law without breaking Shariah principles.

As Shariah principles merely provide a wide boundary within which any law can be applied, this thesis analyses English insurance law first, and then discusses how Islamic insurance policies can operate within the English framework. In many cases, English insurance law crosses the boundary of Shariah principles due to its unfair consequences.

Consequently making English insurance law fairer could be the best solution to allow the use of Islamic insurance policies under English law. Pragmatically, the thesis focuses mainly on problems within current English insurance law and recommends possible solutions. In many cases, the solutions suggested by the Law Commission are found to be incapable of establishing fairness. The majority part of this thesis is spent trying to establish a fairer framework for English insurance law. This fairer English insurance law is found to be Shariah compliant in most cases. In some cases it is not compliant due to operational differences between the two legal systems. In these cases, the thesis recommends that the Islamic insurer should incorporate certain terms to make policies Shariah compliant without breaching English insurance law.

## **DECLARATION**

No portion of the work referred to in the thesis has been submitted in support of an application for another degree or qualification of this or any other university or other institute of learning

## COPYRIGHT STATEMENT

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## ACKNOWLEDGEMENTS

All the praise is due to Allah who made it possible to complete this thesis.

Further to that, the wonderful support and guidance of several people have helped complete the thesis successfully. First and foremost, I would like to express my deepest gratitude to my supervisors Professor Andrew McGee and Annette Nordhausen Scholes at the School of Law, University of Manchester, for their unlimited patience. Their constant guidance and reassurance were great source of encouragement and strength throughout the period of my study.

I would also like to thank the staffs of the John Rylands Library and of the School of Law, especially Jackie Boardman, for all the help they have provided me. I am greatly indebted to the School of Law, University of Manchester for four research fund awards which enabled me to visit Malaysia to learn about their application of Islamic policies and meet academics, to attend and present papers at two consecutive conferences held by ATINER in Athens and the last at the annual conference of Society of Legal Scholars. I am grateful to my brothers Masum and Mahmood for providing me the financial support throughout my study and maternal uncle Mukhlesur Rahman for supporting me with finance and also in Visa proceedings. I am also thankful to Professor Sayed Kamal Uddin Zafree for his time and lecture on Islamic insurance and encouragement. I would like to thank Bangladesh Islami University for providing me financial support for one year.

I am most grateful to my parents, especially my mother, for their unfailing love and support. Many thanks to my parents-in law for their encouragement.

At last not the least, special thanks to my beloved wife, Fahima Hamid, for her tremendous patience, assistance and understanding which truly helped me in completion of the thesis.

## **DEDICATION**

**To my beloved late grandfather Mawlana Azizur Rahman and grandmother Rahima  
Khatun**



## **The Author's Publication and Conference Papers**

Below are the author's published article and conference papers:

### **Article:**

Mahfuz, 'Extent of Professional Duty and Strength of Ratification' June issue (2011) *Journal of Professional Negligence*

### **Book**

Mahfuz, 'The duty of disclosure, both for the insured and insurer' in Professor David A. Frenkel and Dr Carsten Gerner-Beuerle (eds) *Financial Crisis, Globalisation and Regulatory Reform* (1<sup>st</sup> edn, 2012, ATINER)

### **Presentations:**

- (1) Mahfuz 'Disease in Life Policy and Its Cure' (Annual Conference, Society of Legal Scholars, Bristol, September 2012)
- (2) Discussant, (PGR conference, University of Manchester, October 2012)
- (3) Mahfuz 'Want of a proportionate remedy for both the insured and insurer' (8<sup>th</sup> Annual International Conference on Law, Athens, 2011)
- (4) Mahfuz 'Sorry, something is left to be considered' (PGR Conference, University of Manchester, September 2010)
- (5) Mahfuz 'The duty of disclosure, both for the insured and insurer' (7<sup>th</sup> Annual International Conference on Law, Athens, 2010)

## Chapter 1 – Introduction

*'In recent years, Islamic finance has grown rapidly across the world, conservatively estimated at 10-15% a year. Given the UK's position as one of the leading international financial centres, it is no surprise that part of this growth has taken place in London which is now seen as an emerging global 'hub' for Islamic finance.'*

Michael Ainley, 2007<sup>1</sup>

### 1.0 Research Background

'Islamic Finance is growing at an unprecedented speed and is estimated to be worth over \$1 trillion dollars by 2012'.<sup>2</sup> This growth of Islamic finance is not limited to Muslim countries alone. It can also be seen in Western countries, particularly in the UK. A HM Treasury report claims that 'London is the largest Islamic Finance Centre outside the Middle East and Asia'.<sup>3</sup> The Shariah-compliant transactions started in the UK in 1980s.<sup>4</sup> By the 1990s the first retail Islamic products appeared, but saw slow growth until the early 2000s. Since then, the growth has increased following the development of quality of products, the availability of a wider range and the presence of more players in the market. Such growth was also possible due to the positive approach of the UK towards these innovative products.<sup>5</sup> Sir Howard Davies, when Chairman of FSA, said that the UK had 'a clear economic interest in trying to ensure that the conditions for a flourishing Islamic market are in place in London'.<sup>6</sup> Since the early 2000s the Government has introduced a series of tax and legislative changes specifically designed to remove obstacles that hinder the development of Islamic finance.<sup>7</sup> Consequently,

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<sup>1</sup> 'Islamic Finance in the UK: Regulation and Challenges' (November, 2007) FSA 3 <[http://www.fsa.gov.uk/pubs/other/islamic\\_finance.pdf](http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf)> accessed 1<sup>st</sup> November 2011.

<sup>2</sup> Global Islamic Finance Magazine, 'Islamic Finance Spurring Real Growth' <[http://www.globalislamicfinancemagazine.com/index.php?com=news\\_list&nid=1962](http://www.globalislamicfinancemagazine.com/index.php?com=news_list&nid=1962)> accessed 16 November 2012.

<sup>3</sup> 'UK international financial services – the future' (May 2009) 45. <[http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/d/uk\\_internationalfinancialservices070509.pdf](http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/d/uk_internationalfinancialservices070509.pdf)> accessed 16 November 2011. See, Mark Hoban MP, 'Speech by the Financial Secretary to the Treasury, Mark Hoban MP, to the Association of Foreign Bankers', (14 June 2011) HM Treasury Newsroom & speeches <<https://www.gov.uk/government/speeches/speech-by-the-financial-secretary-to-the-treasury-mark-hoban-mp-to-the-association-of-foreign-bankers>> accessed 5 July 2013.

<sup>4</sup> Michael Ainley and others, 'Islamic Finance in the UK: Regulation and Challenges', (2007) FSA 6 <[http://www.fsa.gov.uk/pubs/other/islamic\\_finance.pdf](http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf)> accessed 1st November 2011.

<sup>5</sup> Michael Ainley and others commented that London 'has a tradition going back to the seventeenth century, if not before, of being willing to innovate and respond flexibly to new ideas' in 'Islamic Finance in the UK: Regulation and Challenges', (2007) FSA 7 <[http://www.fsa.gov.uk/pubs/other/islamic\\_finance.pdf](http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf)> accessed 1st November 2011.

<sup>6</sup> Howard Davies, 'Islamic Finance and the UK Financial Services Authority', (Conference on Islamic Banking and Finance, Bahrain, 2 March 2003)

<sup>7</sup> Michael Ainley and others, 'Islamic Finance in the UK: Regulation and Challenges', (2007) FSA 8 <[http://www.fsa.gov.uk/pubs/other/islamic\\_finance.pdf](http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf)> accessed 1st November 2011.

'[t]oday, London is seen by many firms, including Islamic as well as non-Islamic, as an increasingly important global centre for Islamic finance'.<sup>8</sup>

The growth of Islamic finance is principally based on a few products such as the Islamic mortgage, Sukuk (asset backed securities), retail banking. Investors are trying to introduce another product to the UK, Islamic insurance (Takaful). The product 'Takaful' is best explained by section 2 of the Malaysian Takaful Act 1984 which states that it is 'a scheme based on brotherhood, solidarity and mutual assistance which provides for mutual financial aid and assistance to the participants in case of need whereby the participants mutually agree to contribute for that purpose'. This is one of the most successful Islamic financial products in the world market. It has been successful since it was first launched in 1979 in Sudan. Currently, there are roughly 200 companies in the world market providing Takaful insurance.<sup>9</sup> A short review of its success in Sudan provides an example of how successful this product is. In 1992, a Takaful company, named Shiekan Insurance & Reinsurance, collected premiums of \$17,632 and in 2008 the collection of premiums had increased by more than \$600,000.<sup>10</sup> The popularity towards the Takaful product was also increased in unprecedented manner. In 2002-2003 crops Takaful was taken by 6,300 farmers and in 2008-2009 more than 130,000 farmers took this Takaful.<sup>11</sup> Similar success records are found in Malaysia, where the annual growth rate of Takaful assets and net contributions was '27% and 19% respectively from 2003 to 2007'.<sup>12</sup> The global gross for Takaful contributions was \$1,988m in 2005 and an estimated \$8.3 billion in 2010.<sup>13</sup>

Such lucrative growth of Takaful product in the world market has created strong hopes for its success on the UK market, especially considering that there are more than 2 million Muslims

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<sup>8</sup> ibid 6.

<sup>9</sup> A. M. Best 'Takaful Review 2012 Edition' (10 January 2012) 4  
<<http://www.ambest.com/europe/menareport.pdf>> accessed 5 July 2013.

<sup>10</sup> Dr Hatim Abbas Mudawi, 'Takaful Products for the Poor' (April 2010) ICMIF Takaful 3  
<<http://www.takaful.coop/images/stories/ICMIF%20Series%20of%20Articles%20No%2020.%20Takaful%20Products%20for%20poor.pdf>> accessed 16 November 2011.

<sup>11</sup> Data collected from the article written by Dr Hatim Abbas Mudawi, 'Takaful Products for the Poor' (April 2010) ICMIF Takaful  
<<http://www.takaful.coop/images/stories/ICMIF%20Series%20of%20Articles%20No%2020.%20Takaful%20Products%20for%20poor.pdf>> accessed 16 November 2011.

<sup>12</sup> Bank Negara Malaysia, 'Islamic Banking & Takaful'  
<[http://www.bnm.gov.my/index.php?ch=fs\\_mfs&pg=fs\\_mfs\\_bank](http://www.bnm.gov.my/index.php?ch=fs_mfs&pg=fs_mfs_bank)> accessed 26 November 2012.

<sup>13</sup> Ernst & Young, 'Industry Growth and Preparing for Regulatory Change – The World Takaful Report 2012' (April 2012) 10  
<[http://takafulafrica.com/public/uploads/The\\_World\\_Takaful\\_Report\\_2012\\_%20by\\_Ernest\\_Young.pdf](http://takafulafrica.com/public/uploads/The_World_Takaful_Report_2012_%20by_Ernest_Young.pdf)>  
accessed 5 July 2013.

residing in the UK to whom Takaful can be marketed.<sup>14</sup> This product can also be marketed to the non-Muslims as Susan Dingwall, a partner at Norton Rose, explains, the ‘Takaful should not be viewed simply as a niche product for Muslims. It is an ethical product and it should be promoted to a wider market segment as a ‘green’ product, where the investments made from donations [premiums] are invested ethically’.<sup>15</sup> The first company to become a Shariah-compliant insurer in the UK, is Salaam Halal. They started selling the product in the UK in 2008, with 10,000 policyholders within a year.<sup>16</sup> Other companies, such as Iqra Ethical are also interested in launching this product.<sup>17</sup>

It is now obvious that the UK is a potential market for Islamic insurance. Consequently the question becomes whether there are any legal barriers preventing the operation of the Takaful in the UK. There are two parts in an insurance policy, the operational and contractual parts.

#### (1) Operational

In English law, the operational part is governed by the Insurance Companies Regulation 1994, Financial Services and Markets Act 2000 and FSA regulations such as Insurance Conduct of Business Sourcebook (ICOBS).<sup>18</sup> The FSA is the regulatory authority which claims to be secular and announced that they would treat Takaful companies the same as

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<sup>14</sup> Home Office, *Life in the United Kingdom – A Journey to Citizenship* (2<sup>nd</sup> edn, 2007) 38

<sup>15</sup> Reported by Jane Bernstein, ‘Opening the Takaful market’ (22 May 2012) Post online.co.uk <<http://www.postonline.co.uk/post/feature/2179084/takaful-market>> accessed 23 November 2012. See also, Atsuhiko Ayabe, ‘The development of comprehensive takaful products’ in Sohail E. Jaffer (ed), *Regulatory approaches to takaful*, *Islamic Insurance: Trends, Opportunities and the Future of Takaful* (Euromoney Books, London, 2007) 54. Ms Flockhart, senior associate at Norton Rose, commented ‘If insurers can market Takaful in such a way that it appeals to non-Muslim customers in addition to its core Muslim market, then the potential is huge’. The comment was quoted by Sam Barrett, ‘Takaful insurance: A future full of potential’ (30 August 2011) Postonline.co.uk <<http://www.postonline.co.uk/post/feature/2105374/takaful-insurance-future-potential>> accessed 26 November 2012. See also Mohammed Amin and Mohammad Kahn ‘Takaful in the EU: Brimming with Potential’ (February 2008) *Mir Takaful in EU* 58

<sup>16</sup> Jamie Dunkley, ‘Islamic insurance company Salaam Halal closes to new business’ *The Telegraph* (18 November 2009). However, the company have stopped selling the product in 2009 since they are in ‘solvent run-off’. They raised £60m whilst they hoped to raise £80m. It is interesting to note that the critics pointed their fingers to several reasons for their failure but did not doubt the possibility of success of Takaful product in the UK market. See, Sam Barrett, ‘Takaful insurance: A future full of potential’ (30 August 2011) Postonline.co.uk <<http://www.postonline.co.uk/post/feature/2105374/takaful-insurance-future-potential>> accessed 26 November 2012. See also, Jane Bernstein, ‘Opening the Takaful market’ (22 May 2012) Post online.co.uk <<http://www.postonline.co.uk/post/feature/2179084/takaful-market>> accessed 23 November 2012.

<sup>17</sup> See the comment of Lord Mohamed Sheikh, Chairman and Director of Iqra Ethical. The comment was quoted by Jane Bernstein, ‘Opening the Takaful market’ (22 May 2012) Post online.co.uk <<http://www.postonline.co.uk/post/feature/2179084/takaful-market>> accessed 23 November 2012.

<sup>18</sup> FSA announced that there is no restriction in the operation of Islamic policies in the UK as long as the companies satisfy the conditions imposed by FSA. See, Michael Ainley and others, ‘Islamic Finance in the UK: Regulation and Challenges’, (2007) FSA 22 <[http://www.fsa.gov.uk/pubs/other/islamic\\_finance.pdf](http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf)> accessed 1st November 2011.

other companies in the market.<sup>19</sup> Consequently, Takaful operators have to comply with all the existing law.

Takaful operations are different from that of the conventional insurance policies. Unique Shariah principles shape its operation.<sup>20</sup> For example, Shariah prohibits Riba (usury), Gharar (uncertainty), maisir (gambling).<sup>21</sup> Apparently, all Islamic scholars agreed that these prohibited elements are available in conventional policies.<sup>22</sup> As such, different scholars have invented different models of insurance policies that are free from these prohibited elements. These include the Tabarru-based Takaful, Mudaraba-based Takaful, Wakala-based Takaful and the Malaysian model of Takaful.<sup>23</sup> These different categories can be beneficial to companies and consumers when choosing the suitable product for them. However, the real question for entries to the UK market is whether these models comply with the UK regulations. It has been proved by the authorisation of Salaam Halal as a purely Shariah (Islamic law) based insurance company and by its successful operation that these models of Takaful can comply with UK regulations.

## (2) Contractual

This part covers the contractual relations between the insured and insurer such as, when is the insurable interest required to exist, at what stage of the policy should the insured or insurer observe utmost good faith, and if any of them fail to do so, then what should be the remedy. Other issues include subrogation, third party rights, conditions and warranties. The Life Assurance Act 1774, Marine Insurance Act 1906 and common law govern these aspects of English insurance policies. For example, section 18 of Marine Insurance Act says that ‘the assured must disclose to the insurer, before the contract is concluded, every material circumstance which is known to the assured.’

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<sup>19</sup> Michael Ainley and others, ‘Islamic Finance in the UK: Regulation and Challenges’, (2007) FSA 13 <[http://www.fsa.gov.uk/pubs/other/islamic\\_finance.pdf](http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf)> accessed 1st November 2011

<sup>20</sup> The next Chapter will analyse how the Islamic principles shape the Islamic insurance policies.

<sup>21</sup> Each of these elements will be discussed in the next chapter in greater detail.

<sup>22</sup> See, Professor R. Qaiser, ‘Takaful – the Islamic Insurance’ National Insurance Academy, pages 2 -4. <<http://www.niapune.com/pdfs/Research/TAKAFUL%20INSURANCE.pdf>> accessed 27 December 2012; Muhammad Anwar ‘Comparative Study of Insurance and Takaful (Islamic Insurance)’ (1994) 33:4 Part II The Pakistan Development Review 1315, 1317-1319.

<sup>23</sup> Each of these models will be discussed in the next chapter in greater detail.

The Shariah principles shape this part of Islamic insurance policies. The Shariah is based on Quran, Hadith, Ijma and Qiyas.<sup>24</sup> It is said in the Hadith that ‘it is illegal for one to sell a thing if one knows that it has a defect, unless one informs the buyer of that defect’.<sup>25</sup> This means that under this Hadith an insured has the duty of disclosure before taking a policy similar to that of in English law. Consequently, Dingwall, Ali and Griffiths commented that ‘it does not appear that any of the essential elements of an insurance contract (including the doctrine of utmost good faith) are inconsistent with the Shari’a principles governing takaful, and, consequently, it is likely that takaful will have all the essential hallmarks of an insurance contract for the purpose of English law’.<sup>26</sup>

However, English insurance law says that the insurer can avoid the contract *ab initio* for a material non-disclosure even if it was caused by an innocent mistake. This is found to be unfair by the academics,<sup>27</sup> courts<sup>28</sup> and the Law Commission<sup>29</sup>. Whereas the renowned Islamic scholar Abu'l-Husain 'Asakir-ud-Din Muslim states that ‘a careful study of “Kitab al-Buyu” (the book pertaining to business transactions) will reveal the fact that the Holy Prophet (may peace be upon him)...has strongly disapproved all transactions which involve any kind of injustice or hardship to the buyer or the seller’.<sup>30</sup> Hence, some parts of English insurance law contradict the Shariah principles.

It is interesting to note that the basic elements imposed by the English insurance law, such as insurable interest and the duty of disclosure, do not contradict the Shariah principles, but the application of these elements in English law gives rise to the contradiction with Shariah principles. For example, English insurance law requires the existence of insurable interest in every insurance policy. Apparently, all the Islamic scholars believe that Islamic law supports such requirement because this prevents the possibility of gambling.<sup>31</sup> However, English

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<sup>24</sup> Each of them will be discussed in the next chapter in greater detail.

<sup>25</sup> Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari*, Kitab al-Buyu, Vol. III No. 291, pp. 165-166.

<sup>26</sup> Susan Dingwall, Shatha Ali and Ffin Griffiths, ‘Regulatory approaches to *takaful*’ in Sohail E. Jaffer (ed), *Regulatory approaches to takaful*, *Islamic Insurance: Trends, Opportunities and the Future of Takaful* (Euromoney Books, London, 2007) 182. See also, ‘Takaful insurance’, Islamic insurance briefing’ (Norton Rose, November 2003) 2

<sup>27</sup> See, Christopher Butcher, ‘Good faith in insurance law: a redundant concept?’ (2008) JBL 375, 379.

<sup>28</sup> See for instance, *Kausar v Eagle Star Insurance Co Ltd* [1997] CLC 129, 132-133 (Staughton L.J.).

<sup>29</sup> Law Commission, *Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured – A Summary* (17 July 2007) para 9.

<sup>30</sup> Abdul Hamid Siddiqi (tr), *Sahih Muslim* (SH. Muhammad Ashraf, Kashmiri Bazar, Lahore, Pakistan 1973) Vol III, 792.

<sup>31</sup> Dr. Mohd. Ma’sum Billah, ‘Insurable interest: can the modern law be adopted in Takaful operations?’ (2000)

insurance law says that the insurable interest in life policy is only required at the day of taking policy.<sup>32</sup> Consequently, when a creditor insures the life of a debtor and receives the debt amount from the debtor after taking the policy, the former still obtains the insured money if the debtor dies within the policy period. In this case the insured is receiving a 'double recovery' which is unfair for the insurer.<sup>33</sup> According to the Islamic principle of fairness and solidarity between two parties, such double recovery would be illegal. Further to that such opportunity of double recovery may influence the insured to do moral hazard which is also prohibited in Islam. The manner of its application in English law keeps the door open for gambling too. In such circumstances English insurance law contradicts Shariah principles.

Accordingly, the application of Islamic policies is hindered by the English insurance law. However, following *Shamil Bank of Bahrain EC v Beximco Pharmaceutical Ltd (No. 1)*, the courts will not consider the Shariah principles when deciding a case.<sup>34</sup> In this case, a term of the contract stated that the governing law should be Shariah principles. The Court of Appeal rejected this choice of law on two grounds. Firstly, that there is no provision in English law for the choice of application a non-national system of law and that the application of Shariah principles is a matter of debate, even in Muslim countries. Consequently, it would be a useless operation for any Islamic insurers to apply insurance policies in the UK without addressing the inconsistencies first. Ainley and others, therefore, commented that '[t]o mitigate this risk, contracts have to be written very carefully to minimise potential disputes'.<sup>35</sup> In writing the contractual terms Islamic insurers have to take two measures, they have to find the existing inconsistencies between English insurance law and Sharia principles in each part of an insurance contract and write the terms of the contract in such a way that makes the policy compliant with both English law and Shariah principles. Also, when choosing the wording of those terms, they have to be as specific as possible, to prevent debate caused by different opinions of Islamic scholars on any issue.

The author could find no research that addresses the aforementioned inconsistencies between current English insurance law and Shariah principles. However, some research can be found

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Arab Law Quarterly 206.

<sup>32</sup> *Dalby v India and London Life-Assurance Co* (1854) 15 CB 365, 139 ER 465.

<sup>33</sup> See, Dr. Mohd. Ma'sum Billah, 'Insurable interest: can the modern law be adopted in Takaful operations?' (2000) Arab Law Quarterly 206, 207.

<sup>34</sup> [2004] EWCA Civ 19; [2004]1 W.L.R. 1784; [2004]4 All ER 1072.

<sup>35</sup> Michael Ainley and others, 'Islamic Finance in the UK: Regulation and Challenges', (2007) FSA 17 <[http://www.fsa.gov.uk/pubs/other/islamic\\_finance.pdf](http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf)> accessed 1st November 2011.

that analyses the contractual part of Islamic insurance policies in Malaysia where a separate Takaful Act operates. However, the Takaful Act 1984 does not deal with the contractual part of insurance. This means that academics are struggling to propose a solution of applying the elements of the insurance contract to Islamic insurance policies. For example, Nusaibah Mohd Parid remained vague on whether the element 'insurable interest' should be required in Islamic insurance contracts or not, and if it is required, how it should be applied leaving the matter for other academics to decide.<sup>36</sup> Whilst the presence of the Takaful Act 1984 makes it far easier for Malaysian academics to identify the contractual position of Islamic insurance contracts, the absence of a separate Act for Islamic insurance makes it more difficult for Islamic insurers to apply their policies in English law. Consequently, research is required to show how Islamic insurance contracts can operate without violating both English law and Shariah principles.

### **1.1 Research Questions**

Following the aforementioned discussion it is revealed that there are inconsistencies between English insurance law and Shariah principles. Where the inconsistency exists Islamic insurers will not be allowed to apply the Shariah principles as opposed to the English insurance law meaning that the policies will violate the former principles.<sup>37</sup> Whereas, Allah (SWT) and His messenger Prophet Muhammad (PBUH) said that if any contract does not follow the Shariah principles it cannot be treated as valid in Islam.<sup>38</sup> As such, the application of Islamic policies in English law, without making them both English law and Shariah compliant, is useless. In such circumstances, it is required to identify how to make their application worthwhile. This means that, the principal question for this research is how to apply the Islamic policies in English law whilst complying with both Shariah and English law. The following section is used to identify the best possible way to apply the purpose of this thesis.

### **1.2 Aim of the Research**

As announced, the fundamental aim of this thesis is to find possible solutions as to how to apply Islamic insurance policies in the English legal system without breaching its insurance

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<sup>36</sup> Nusaibah Mohd Parid, 'Insurable Interest in Takaful Practices: an Analysis', (2009) 3 ISRA Research Paper 1, 29-32.

<sup>37</sup> See for instance, *Shamil Bank of Bahrain EC v Beximco Pharmaceutical Ltd (No. 1)* [2004] EWCA Civ 19; [2004]1 W.L.R. 1784; [2004]4 All ER 1072.

<sup>38</sup> See for instance, Abdul Hamid Siddiqi (tr), *Sahih Muslim* (SH. Muhammad Ashraf, Kashmiri Bazar, Lahore, Pakistan 1973) Vol III, 792.



law whilst complying with Shariah principles. The Shariah based contractual terms can be applied in a legal system in several ways:

(1) Creating a separate Act specifying Shariah based contractual terms in an Islamic insurance contract. In such case, the research should consider only the Shariah position in Islamic insurance contracts. For example, the articles written in Malaysian context purely consider the Shariah position leaving the conventional position apart.<sup>39</sup> However, the FSA has already announced that the UK government would not create or change any law considering the Shariah principles, as it intends to create 'a level playing field' for everyone.<sup>40</sup> Consequently, this option cannot be followed in the UK.

(2) Including provisions in an existing Act purely for Islamic insurance contracts. This option cannot be followed for the reason identified at the first option.

(3) Incorporating specific terms in the contract making it both Shariah and English law compliant. For example, current English insurance law allows the insurer to avoid the contract *ab initio* if the insured fails to disclose a material fact due to his innocent mistake. The remedy is harsh and unfair,<sup>41</sup> and as such is not permitted by Shariah principles.<sup>42</sup> In such a case the insurer should incorporate specific term stating that the insurer will not avoid the contract in these circumstances making the policy Shariah compliant. This is a route to escape from the consequence of English insurance law. This approach requires the consideration of each and every part of English insurance law to discover the inconsistencies between Shariah and English law and then suggest how the terms should be incorporated. The drawback of this approach is that it would lead to a contract having a greater number of conditions which would complicate the business relationship. It can be said that the parties in *Shamil Bank of Bahrain EC v Beximco Pharmaceutical Ltd (No. 1)*,<sup>43</sup> discussed above,

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<sup>39</sup> See for instance, Nusaibah Mohd Parid, 'Insurable Interest in Takaful Practices: an Analysis', (2009) 3 ISRA Research Paper 1.

<sup>40</sup> See, Howard Davies, 'Islamic Finance and the UK Financial Services Authority', (Conference on Islamic Banking and Finance, Bahrain, 2 March 2003); Michael Ainley and others, 'Islamic Finance in the UK: Regulation and Challenges', (2007) FSA 11 <[http://www.fsa.gov.uk/pubs/other/islamic\\_finance.pdf](http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf)> accessed 1 November 2011. at page 11 he summarised the approach of FSA towards the Islamic finance as 'no obstacles, but no special favours'.

<sup>41</sup> See for instance, *Kausar v Eagle Star Insurance Co Ltd* [1997] CLC 129, 132-133 (Staughton L.J.).

<sup>42</sup> *The Holy Quran* 4: 58.

<sup>43</sup> [2004] EWCA Civ 19; [2004]1 W.L.R. 1784; [2004]4 All ER 1072.

intended to avoid this approach by stipulating that governing law would be Shariah principles as a short cut.

(4) Finding the reasons for such inconsistencies and eliminate or reduce (if not possible to completely eliminate) them with necessary steps. This thesis will show how the majority of inconsistencies exist because of the way in which English law seeks to achieve its aims. Their aims are to establish a fair balance between the interests of the parties in the contract,<sup>44</sup> prevent gambling in the guise of insurance<sup>45</sup> and reduce the chance of moral hazard.<sup>46</sup> Similar aims are also adopted by Shariah principles.<sup>47</sup> Hence, many of the inconsistencies can be substantially reduced or eliminated if English law is steered on to the right track<sup>48</sup>. The project of directing the English insurance law to the right track has been taken by the Law Commission. The approaches taken by the Law Commission may not be considered as 'right' by some, but attempts to bring the law onto the right track should be continued.

The thesis has taken the opportunity to contribute to the current Law Commission's discussion to gain two benefits. Firstly, creating the opportunity to bring the diverted parts of English insurance law onto the right track through suggesting new approaches and, secondly, reducing or eliminating the difficulties in the application of Islamic policies in the English legal system by bringing the English insurance law onto the right track.

However, it is discovered in this thesis that in some cases the inconsistencies exist due to the fundamental differences between English insurance law and Shariah principles such as the Shariah principles do not allow any usury,<sup>49</sup> whilst the English law allows such thing. Hence, it is not possible to eliminate the inconsistencies completely by following the above steps. In such cases the thesis will recommend the incorporation of certain terms in the Islamic

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<sup>44</sup> See for instance, Section 228(2) of Financial Services and Markets Act 2000. The section requires the ombudsman to decide a case fairly and reasonably considering the circumstances of the case. See also, Law Commission and Scottish Law Commission, *Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured* (Consultation Paper No 182, Discussion Paper No 134, 2007) Para 1.1.

<sup>45</sup> See, the Preamble of Life Assurance Act 1774. See also, Law Commission and Scottish Law Commission, *Insurance Contract Law: Issues Paper 4 Insurable Interest* (14 January 2008) para 2.4.

<sup>46</sup> Law Commission and Scottish Law Commission, *Insurance Contract Law: Issues Paper 4 Insurable Interest* (14 January 2008) para 2.3.

<sup>47</sup> See for instance, Abdul Hamid Siddiqi (tr), *Sahih Muslim* (SH. Muhammad Ashraf, Kashmiri Bazar, Lahore, Pakistan 1973) Vol III, Introduction to Kitab al-Buyu; *The Holy Quran*, 5: 90; Nusabih Mohd Parid, 'Insurable Interest in Takaful Practices: an Analysis', (2009) 3 ISRA Research Paper 1, 5-6.

<sup>48</sup> There may be debates regarding the track which should be right for the English insurance law, but it is obvious to everyone that some parts of the current law are in the wrong track.

<sup>49</sup> See for instance, *The Holy Quran*, 2:275.

insurance contract so as to make it both English law and Shariah principles compliant. Hence, the approach of this thesis is a combination of the third and fourth approaches.

In summary, the thesis will contribute in three ways. By contributing to the current Law Commission's discussion of modifying the current English insurance law so as to achieve its fundamental principle of establishing fairness between the parties in the contract, preventing gambling in the guise of insurance and reducing the chance of moral hazard. Secondly, by finding whether each of the proposed steps for modifying the current English insurance law is consistent with the Shariah principles. Finally, by recommending certain terms to be incorporated in Islamic insurance policies where the proposed step for modifying the current English insurance law fails to make the law consistent with Shariah principles.

There is an important issue identified by the court in *Shamil Bank of Bahrain EC v Beximco Pharmaceutical Ltd (No. 1)*<sup>50</sup> that Shariah principles are fluid in nature and different scholars have different opinions on the same issue. Consequently, critics may argue as to how it is possible to consider the recommendations of the author as appropriate for Islamic policies.

### **1.3 Fluid Nature of Shariah principles and the Effect of Author's Recommendations**

It is discussed in Chapter Two that Shariah principles derive from four sources. The principal sources are the Quran and Sunna. As Prophet (PBUH) says

تركت فيكم أمرين لن تضلوا ما تمسكتم بهما كتاب الله وسنة نبيه

*I left two things among you. You shall not go astray so long as you hold on to them. These are the book of Allah (Qur'an) and the Sunnah of His Messenger.*<sup>51</sup>

On the other hand, Allah (SWT) does not want to specify every law. As He said

يأيتها الذين ءامنوا لاتسألوا عن أشياء إن تبدلكم تسؤكم

*O you who have believed, do not ask about things which, if they are shown to you, will distress you.*<sup>52</sup>

<sup>50</sup> [2004] EWCA Civ 19; [2004]1 W.L.R. 1784; [2004]4 All ER 1072.

<sup>51</sup> كتاب الجامع, باب القدر, 1661 Imam Malik, *Al-Muatta*.

<sup>52</sup> *The Holy Quran*, 5:101.

According to the verse of the Qur'an some rules should be developed by the scholars. However, according to the above mentioned Hadith it also becomes apparent that no one can go beyond the rules of Qur'an and Sunnah. Consequently, the rules given by the Quran and Sunnah cannot be violated in any circumstances. Accordingly, the issues on which no rule is provided or the rule is intentionally kept vague the scholars have to research on them.<sup>53</sup> Hence Prophet (PBUH) encouraged research saying

الحاكم إذا اجتهد فأصاب فله أجران وإن اجتهد فأخطأ فله أجر

*When a judge exercises ijthad (research) and gives a right judgment, he will have two rewards, but if he errs in his judgment, he will still have earned one reward.*<sup>54</sup>

In effect of this there are four famous schools or groups have been created by four famous scholars, Hanafi, Hanbali, Shafi'i and Maliki. No one can claim that a particular explanation of the law or view is wrong. For example, it is mentioned by Imam Malik that

Said ibn al-Musayyab say, "Umar ibn al-Khattab decided on a camel for each molar, and Muawiya ibn Abi Sufyan decided on five camels for each molar." Said ibn al-Musayyab said, "The blood-money is less in the judgement of Umar ibn al-Khattab and more in the judgement of Muawiya. Had it been me, I would have made it two camels for each molar. That is the fair blood-money, and everyone who strives with ijthad is rewarded."<sup>55</sup>

Hence, it is submitted that the government of a country can choose the law explained by the scholars whose views are mostly followed by the citizens of that country. For example, in Saudi Arabia the majority follows the opinion of Hanbali school. In Bangladesh, the majority follow the opinion of Hanafi school. However, it has already been stated that there cannot be any separate law for Islamic policies in the English land. Hence, the parties of the Islamic insurance contracts in the UK can choose any of the schools' opinion or they may combine them to follow market demand or to comply with the English law. Consequently, terms for Islamic insurance contracts adopted by one Islamic insurer may differ from that of the other Islamic insurer. In every case these insurers have to consider the essential factor that their adopted terms do not violate the English law.

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<sup>53</sup> Example of the rule that creates different opinion is given in the second chapter.

<sup>54</sup> *Abu Dawud, Sunan*, III, 1013, Hadith No. 3567.

<sup>55</sup> Imam Malik bin Anas, *Al-Muwatta*, (USC Centre for Muslim-Jewish Engagement tr, <<http://www.usc.edu/org/cmje/religious-texts/hadith/muwatta/043-mmt.php>>) Book 43, Number 43.12.7 accessed 05/07/2013.

As stated above, the aim of this thesis is to discover the framework by which Islamic insurance policies can be applied in English law without violating Shariah principles or English insurance law. Modifying existing English insurance law so as to achieve its ultimate target of establishing fair balance, preventing gambling in guise of insurance and reducing moral hazard would significantly open the opportunity for the application of Islamic insurance policies. As such, this thesis will analyse how parts of English insurance law can be brought back onto the right track so as to achieve those targets. The target of establishing fairness may create some uncertainties since 'fairness' depends on subjective judgment as found in the different opinions of above-mentioned Islamic scholars. This thesis will attempt to justify the point of view taken by considering examples and the views of other academics. It is a matter of fact that anyone can differ on the basis of their own justification. Consequently, it is for the lawmakers and Islamic insurers to choose which view they would prefer when establishing a fair balance.

#### **1.4 Research Methodology**

The research is conducted using qualitative methods, which is complemented by legal resources (both primary and secondary sources).<sup>56</sup> Since the aim of the research is to modify English insurance law to accommodate Islamic principles the research mainly considers how the unfair parts of English insurance law can be made fairer. Taking these issues into consideration the research will analyse English insurance law so as to find the loopholes that are acting as barriers against achieving those aims. In order to justify the existence of these loopholes the thesis will consider the views of academics, Law Commission, the courts and hypothetical examples.

The suggestions for covering those loopholes provided by the Law Commission and academics will also be analysed to find out how far these recommendations will succeed. The thesis will go beyond the limit of these recommendations and carefully examine the laws of Australia and in some cases the laws of Malaysia and USA. The author's recommendations will then be made following such constructive analysis.

Following the lack of mentionable statutory rules governing the Islamic insurance policies, over the world, the research will mainly focus on the Quran and Hadith in order to justify

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<sup>56</sup> The former consists statutes (UK, Australia, Malaysia), common law and Shariah sources (Quran and Hadith) the latter consists reports, journal articles and legal reforms.

whether the recommended English insurance laws are consistent with Sharia principles. Different legal frameworks suggested by the academics will also be carefully examined. Following such constructive analysis the thesis will justify whether there is any need for separate terms to make the Islamic policies both English law and Sharia compliant. The thesis will suggest the nature of the term that should be incorporated into the contract where, following the careful analysis, it is found that the proposed English insurance law is inconsistent with the Sharia principles.

### **1.5 Scope and Boundaries of the Research**

It is apparent from the above discussion that the thesis will contribute to the modification of parts of English insurance law where it is considered to be unfair, so as to achieve its ultimate targets, it will also analyse whether the modified English insurance law would be consistent with Shariah principles. In order to achieve these targets it is required to analyse every part of an insurance contract. There are several parts to an insurance contract, including insurable interest, utmost good faith, warranties and conditions, premiums, assignment, subrogation, third party rights. It is impossible to research all of these parts within the word limit for this thesis. Consequently, the research starts by analysing first two of those parts, insurable interest and utmost good faith. The latter parts will be analysed in further research so as to complete the whole project. The current research is also limited to consumer insurance for the aforementioned reason. The future research, after completion of this PhD, will also cover the business insurance.

The thesis was mainly completed on 1<sup>st</sup> December 2011. Accordingly the research is conducted on the laws and recommendations of the Law Commission that were available before that period. However, the Law Commission published a consultation paper on 20<sup>th</sup> December 2011, prior to the submission of the thesis. The author, therefore, will add the summary of the latest recommendations as an appendix to the relevant chapter so as to keep the reader informed regarding the latest updates. The cut-off period of this update is 30 April 2013. On 1 April 2013, the FSA was divided into two parts, the Financial Conduct Authority,<sup>57</sup> and the Prudential Regulation Authority.<sup>58</sup> The thesis refers FSA in several places. Since the thesis was completed long before the division the references to FSA will

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<sup>57</sup> The aim of the body is to protect consumers, ensure the industry remains stable and promote healthy competition between financial services providers.

<sup>58</sup> This body is responsible for the prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms.

still remain. A further update is required to be mentioned regarding the enforcement of the Consumer Insurance (Disclosure and Representations) Act 2012. The Act came into force on 6 April 2013 which was enacted following the Bill ‘Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation’. The thesis refers to the Bill instead of the Act for the previously mentioned reason. However, the eventual Act did not change the parts of the Bill that are referred to in this thesis.

## **1.6 Structure**

The thesis comprises eight chapters. Chapter Two discusses the background of English insurance, Islamic insurance and their legal sources. English insurance law was developed following the market structure and peoples’ demand. Whereas, Shariah principles are fixed by their sources which cannot be violated. Consequently, the structures of Islamic insurance policies have to be created following the Shariah principles. Islamic scholars, therefore, invented different models of insurance policy that comply with the Shariah, which are also discussed in this chapter.

Chapter Three analyses the first part of insurance contract, which is insurable interest. The main purpose of imposing the requirement of insurable interest is to prevent gambling in the guise of insurance.<sup>59</sup> The Chapter points out that the chance of gambling still exists due to misapplication of the requirement. Some academics argue that the requirement of ‘insurable interest’ should be abolished.<sup>60</sup> Their main example is Australia which have already abolished this requirement. However, the Law Commission, are in favour of keeping the requirement. The Chapter discusses both the advantages and disadvantages of this requirement and provides recommendations that should be successful in reducing the chance of gambling and creating a fair balance between the rights of the insured and insurer. The Chapter also discusses the views of Islamic scholars in relation to insurable interest.

Chapters Four to Seven analyse the rule of utmost good faith. Chapter Four discusses the duty of an insured and insurer before commencing a policy. It analyses how unfair the current duty is and examines the effect of the Bill proposed by the Law Commission on consumer insurance. It is argued that this proposed law will fail to establish fairness and as such new

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<sup>59</sup> See, the Preamble of Life Assurance Act 1774.

<sup>60</sup> See for instance, Jacob Loshin ‘Insurance Laws’ Hapless Busybody: A Case Against the Insurable Interest Requirement’ (2007) *The Yale Law Journal* 474, 508; Wickens, ‘Policy Provisions of the Life Insurance Act’, (1969) *Transactions of the Institute of Actuaries of Aust. And N.Z.* 189, 201.

approach is recommended. The remedy for breach of the duty is discussed in the Chapter Five.

Two categories of duties are imposed on an insured and insurer after the policy commences. One is during the policy period and the other is during the claim procedure. Chapter Six discusses the duties and Chapter Seven discusses the remedy for breach of those duties. Accordingly both of these chapters are divided into two parts, discussing the policy period and then discussing the claim procedure.

Chapter Eight is the conclusion of the thesis and provides the overview of the current position of English insurance law and recommendations made to develop the law so as to accommodate Shariah principles.



## **Chapter 2 – Introduction to English and Islamic Insurance and their Legal Sources**

### **2.0 Introduction**

The concept of both Islamic and English insurance have emerged from a very similar background,<sup>61</sup> namely an agreement among a group of people to share certain risks among themselves. The main difference is the period in which they emerged. The practice of such an agreement can be found in the Islamic era at the beginning of 600 AC, whereas such practice started in England during in the sixteenth century. Nonetheless, the practice of insurance in England developed so rapidly that the Islamic insurance is now following English insurance.

English insurance is now applied against almost every kind of risk changing the theory of the policy to the transfer of the risk in the hand of insurer in return for premiums. It is apparent that the nature of English insurance policies can be changed following the market's demand within the law, but the nature of Islamic policies must obey pre-set Islamic rules. The Islamic scholars invented some models of Islamic policies following those rules. These invented models have successfully complied with the English company regulations. Whilst research has been undertaken in developing the formation or modelling the Takaful products, no significant research has been undertaken that develops their contractual parts. The situation is worse where it comes to the application of these models in the English legal system, as there has been little or no research in remedying the situation where the Shariah principles governing the contractual part of an insurance policy contradicts with English insurance law. However, this thesis will identify that these contradictions can be reduced by making the English law fair and reasonable. The question of fairness is subjective. However, in some points different concepts of fairness can be reconciled.

### **2.1 Brief History of Insurance**

It is found that the ancient Phoenicians, the Greeks, the Romans used to guard themselves against some of the risks of maritime enterprise by various systems of insurance,<sup>62</sup> whether in

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<sup>61</sup> Antony Hainsworth, 'Retakaful, regulation and risk: developing the Islamic insurance market in the UK' 4 (2009) 4 *Journal of International Banking and Financial Law* 193, 193.

<sup>62</sup> However, there are some historians like Grotius, Bynkershoek, Part, Marshall and Hopkins argue that these transactions were other than the insurance since there cannot be found any trace of insurance contract in the laws of Rome or of any of the other ancient peoples.

the shape of loans or of mutual guarantee.<sup>63</sup> The loan form is known as ‘Bottomry’. The Bottomry is defined ‘as the mortgage of a ship, i.e. her bottom or hull, in such a manner that, if the ship be lost, the lender likewise loses the money advanced on her; but that, if she arrives safely at the port of destination, he not only gets back the loan, but receives, in addition, a certain premium previously agreed upon’.<sup>64</sup> Bottomry is the forerunner of today’s Marine insurance practices.<sup>65</sup> The difference between Bottomry and today’s insurance practice is that the compensation is advanced before the actual loss in Bottomry and the compensation is paid after the actual loss in the modern method of insurance.

The practice of insurance as mutual guarantee is as old as human society itself.<sup>66</sup> This used to be practiced through friendly societies ‘organised for the purpose, among others, of extending aid to their unfortunate members from a fund made up of contributions from all’.<sup>67</sup> These societies are ‘as old as recorded history,’<sup>68</sup> and such practice existed in China and India in the earliest times.<sup>69</sup> Among the Greeks these societies, known as *Eranoi* and *Thiasoi*, are known to have existed as early as the 3 BCE.<sup>70</sup> Similar societies, called *Collegia*, existed in Rome.<sup>71</sup> These Roman *Collegia* subsequently appeared in history as mediaeval guilds.<sup>72</sup>

It is to be noted that some historians do not consider such practices as insurance.<sup>73</sup> In their view the earliest record of insurance can be found ‘in a work written by Villani, an Italian historian who died in 1348, in which it is stated that a system of Marine Insurance was devised by the Jews in 1182’.<sup>74</sup> They introduced the system of insurance to Lombardy during this period. On the basis of this statement it is argued that the Jews introduced ‘the idea to the Italians who improved upon it, and from whom it was copied by other nations’.<sup>75</sup>

However, it is accepted by all historians that the word ‘insurance’ as it is understood in the

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<sup>63</sup> See, Frederick Martin, *The History of Lloyd’s and of Marine Insurance in Great Britain* (Macmillan and Co. 1876) 2.

<sup>64</sup> *ibid* 2-3.

<sup>65</sup> *ibid* 3.

<sup>66</sup> W. R. Vance, ‘The Early History of Insurance Law’ (1908) VIII (1) *Columbia Law Review* 1, 3.

<sup>67</sup> *ibid* 3.

<sup>68</sup> *ibid* 3.

<sup>69</sup> *ibid* 3.

<sup>70</sup> *ibid* 3.

<sup>71</sup> *ibid* 3.

<sup>72</sup> *ibid* 4.

<sup>73</sup> H. G. Lay, *History of Marine Insurance including the Functions of Lloyd’s Register* (Post Magazine 1925) 2-3. See also W. R. Vance, ‘The Early History of Insurance Law’ (1908) VIII (1) *Columbia Law Review* 1, 3.

<sup>74</sup> *ibid* 2.

<sup>75</sup> *ibid* 2.

modern sense has first appeared in the old work called the “Chronyk van Vlaendern”...as early as the beginning of the fourteenth century’ in Bruges.<sup>76</sup> In the same place, the two major groups of merchants of this period, the Hanseatic League<sup>77</sup> and Lombards,<sup>78</sup> established the first insurance market in 1310.<sup>79</sup>

## 2.2 Brief History of English Insurance

During the Middle Ages nearly all English foreign trade, including insurance, was handled by the Hansa merchants and Lombards who had taken up residence in London.<sup>80</sup> The Hansa merchants were expelled from London in 1597 by a proclamation issued by Elizabeth I. The Proclamation did not apply to the Lombards but they faced certain restrictions on the operation of their business. Subsequently, they withdrew from London.

It is accepted by historians that the system of insurance was introduced to English people by the Hansa merchants and Lombards.<sup>81</sup> The first confirm record of an insurance transaction in England,<sup>82</sup> is found in the report of the case of *Emerson c. De Sallanova*,<sup>83</sup> decided in an admiralty court in 1545. The insurance in this case was taken against the possible loss consequent upon the withdrawal by the King of France of a safe conduct. The earliest English policy of marine insurance was issued in 1613.<sup>84</sup> During the early part of 17<sup>th</sup> Century, marine insurance was conducted as a sideline by bankers, moneylenders and

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<sup>76</sup> Frederick Martin, *The History of Lloyd's and of Marine Insurance in Great Britain* (Macmillan and Co. 1876) 6. See, W. R. Vance, ‘The Early History of Insurance Law’ (1908) VIII (1) Columbia Law Review 1, 8; H. G. Lay, *History of Marine Insurance including the Functions of Lloyd's Register* (Post Magazine 1925) 7.

<sup>77</sup> The Hanseatic League was founded by the merchants who were driven northward from Central Europe by the invading barbarians. A number of these merchants settled down on the shores of the Baltic and North Sea, notably at Lubeck and Hamburg. The League was actually formed by the inhabitants of these two cities, and is known to have been in existence in 1226.

<sup>78</sup> The Lombards were a Germanic tribe that began in southern Sweden and worked their way down into Italy. They became Italians in the process and gave their name to the northern Italian region of Lombardia. In 1236 Lombardy was laid waste in the war waged between the Kaiser Frederick of Germany and Papal Authority, and the Lombard merchants were driven from their home and settled in various cities and towns. A number of them migrated to London.

<sup>79</sup> Frederick Martin, *The History of Lloyd's and of Marine Insurance in Great Britain* (Macmillan and Co. 1876) 6. See, W. R. Vance, ‘The Early History of Insurance Law’ (1908) VIII (1) Columbia Law Review 1, 8; H. G. Lay, *History of Marine Insurance including the Functions of Lloyd's Register* (Post Magazine 1925) 7.

<sup>80</sup> H. G. Lay, *History of Marine Insurance including the Functions of Lloyd's Register* (Post Magazine 1925) 16. See, W. R. Vance, ‘The Early History of Insurance Law’ (1908) VIII (1) Columbia Law Review 1, 11.

<sup>81</sup> See, *ibid* 16; W. R. Vance, ‘The Early History of Insurance Law’ (1908) VIII (1) Columbia Law Review 1, 11; Frederick Martin, *The History of Lloyd's and of Marine Insurance in Great Britain* (Macmillan and Co. 1876) 33.

<sup>82</sup> See, W. R. Vance, ‘The Early History of Insurance Law’ (1908) VIII (1) Columbia Law Review 1, 11-12.

<sup>83</sup> Selden Soc. Pub., Vol. XI, p. Ixvi.

<sup>84</sup> See, Frederick Martin, *The History of Lloyd's and of Marine Insurance in Great Britain* (Macmillan and Co. 1876) 46.

merchants.<sup>85</sup> During 1650s several coffee houses opened where businessmen met to conduct business. Out of these coffee houses Lloyd's Coffee House achieved a lasting fame and became the first recognised home of marine insurance. During this period there were no specific insurance company. An application for insurance would be carried to different merchants. If favourably disposed, the individual would sign his name to the application, with the amount which he was willing to pay in the event of total loss. From this system of placing the risks the word 'underwrite' was derived and the individuals who signed, came to be known as 'underwriters'.<sup>86</sup>

Insurance against fire risk, principally developed in England after the Great Fire of London in September 1666.<sup>87</sup> Before this period medieval guilds used to provide mutual help for their members and some charities supported the victims such as through brief system.<sup>88</sup> The proposals to establish fire insurance in England had been made in 1635 and 1638. But it was finally established after the Great Fire in 1666. Barbon established an office for fire insurance in 1667 which was transferred to a company in 1680. 'In 1682 the City of London started a rival undertaking. About the same time two partners established a mutual society known as the Friendly Society; and in 1696 another mutual society, known as the Hand in Hand, was started.'<sup>89</sup>

The concept of life insurance was known in England before the fire insurance developed. During sixteenth and seventeenth centuries a few insurances against certain risks to the person were applied. These policies are seen as 'the germs from which our modern life and accident insurance have grown up'.<sup>90</sup>

It is apparent from this short history that the English were introduced to the concept of insurance during the middle ages. Since this period, the English have successfully developed this financial concept to its current modern level. However, the legal aspect of

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<sup>85</sup> H. G. Lay, *History of Marine Insurance including the Functions of Lloyd's Register* (Post Magazine 1925) 17.

<sup>86</sup> See, William D. Winter, *A Short Sketch of the History and Principles of Marine Insurance* (The Insurance Society of New York, October 1925) 10.

<sup>87</sup> Robert Evans, 'The Early History of Fire Insurance' (30 July 2007) *The Journal of Legal History* 88, 88.

<sup>88</sup> 'Briefs by letter patents were documents bearing the royal signature addressed to bishops and clergy recommending and authorising the collection of money in churches for charitable purposes.' Robert Evans, 'The Early History of Fire Insurance' (30 July 2007) *The Journal of Legal History* 88, 88.

<sup>89</sup> W. S. Holdsworth, 'The Early History of the Contract of Insurance' (Feb. 1917) *Vol. 17, No. 2 Columbia Law Review* 85, 109.

<sup>90</sup> *ibid* 110-111.

this financial concept has not been developed to the same extent.

### 2.3 Legal Sources of English Insurance

Early insurance disputes were settled by conventional merchant courts or arbitrators since the common law courts did not recognise the quasi-international customs of merchants and as such ‘afforded no fit forum for the determination of cases between merchants’.<sup>91</sup> However, ‘there were probably many cases in which the underwriters refused to perform the judgments of the merchant courts, whose great weakness lay in the lack of a sheriff’.<sup>92</sup> Consequently, the merchants turned to the courts of admiralty, but these courts ‘did not prove satisfactory tribunals for the determination of insurance causes’.<sup>93</sup> In such circumstances ‘litigants sometimes felt compelled to carry insurance causes to the common law courts’.<sup>94</sup> But the common law courts of that day ‘were ill adapted for the settlement of merchants’ disputes’.<sup>95</sup> Finding no other solution the merchants and underwriters sought relief from Parliament and secured, The Insurance Act 1601, the first English insurance Act.<sup>96</sup>

By the provisions of the Act authority was given to the Lord Chancellor or to the Lord Keeper of the Great Seal to issue court of insurance commissioner. This court, however, was unsuccessful and as such ‘lapsed into disuse and died of inanition within a century after its creation’.<sup>97</sup> Consequently, the law of insurance did not develop until the appointment of Lord Mansfield as Chief Justice of the Court of Kings Bench in 1756.<sup>98</sup> However, some development can be found with the Marine Insurance Act of 1745.<sup>99</sup> This Act prohibited the issue of policies without interest and also policies of reinsurance, ‘which in those days were regarded similarly to wager policies’.<sup>100</sup>

After being appointed as Chief Justice, Lord Mansfield increased the involvement of

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<sup>91</sup> W. R. Vance, ‘The Early History of Insurance Law’ (1908) VIII (1) Columbia Law Review 1, 12.

<sup>92</sup> *ibid* 13.

<sup>93</sup> *ibid* 13.

<sup>94</sup> *ibid* 13-14.

<sup>95</sup> *ibid* 14.

<sup>96</sup> 43 Eliz., c. 12.

<sup>97</sup> W. R. Vance, ‘The Early History of Insurance Law’ (1908) VIII (1) Columbia Law Review 1, 15. See, H. G. Lay, *History of Marine Insurance including the Functions of Lloyd’s Register* (Post Magazine 1925) 98.

<sup>98</sup> *ibid* 16. See also, H. G. Lay, *History of Marine Insurance including the Functions of Lloyd’s Register* (Post Magazine 1925) 99-100.

<sup>99</sup> 19 Geo. 2, c. 37.

<sup>100</sup> H. G. Lay, *History of Marine Insurance including the Functions of Lloyd’s Register* (Post Magazine 1925) 99.

common law courts in solving insurance disputes. He applied principles derived from the law merchant as well as more traditional common law concepts, and by the time of his retirement in 1788, the jurisdiction of the courts over insurance matters had been established. The Marine Insurance Act 1906 'merely gave legislative effect to decisions of this famous judge'.<sup>101</sup> Meanwhile Parliament enacted the Life Assurance Act in 1774. Both of these Acts are still in operation. There is, however, no separate Act for general insurance contracts. The courts therefore apply the common law and relevant sections of the Marine Insurance Act 1906 to decide the general insurance causes.

In this modern era these laws are considered to be outdated since they are harsh and illogical considering the modern concept of the market. They also fail to establish fairness between the insured and insurer.<sup>102</sup> The Law Commission, therefore, have taken steps to develop the law of consumer insurance policies considering the present market demands. They have already published several issues papers and also recommended to separate the treatment of business and consumer insurance. Following the Law Commission's recommendations Parliament passed the Consumer Insurance (Disclosure and Representations) Act 2012. This came into force on 6th April 2013. The Law Commission have published issues papers on 'insurable interest', 'post contract duties', 'claim procedure' 'warranty'. It is, therefore, expected that in the near future England will have a new set of insurance laws.

#### **2.4 A Brief History of Islamic Insurance**

In Islamic term the, insurance is called 'Takaful' (mutual guarantee) or 'Ta'awun' (mutual cooperation). Takaful or ta'awun is not a contract of buying and selling of protection. Rather, it is an arrangement amongst a group of people with a common interest to guarantee or protect each other from an unwanted peril through the creation of a defined pool formed from out of their common resources. The theory of this policy is derived from various Quranic verses and Ahadith (plural of Hadith) that ask believers to cooperate with each other in hardship. Allah (SWT) says in the Quran:

وتعاونوا على البر والتقوي- ولا تعاونوا على الإثم والعدوان- والتقوا الله

*And cooperate in righteousness and piety, but do not cooperate in sin and aggression. And fear Allah.*<sup>103</sup>

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<sup>101</sup> ibid 100.

<sup>102</sup> Their nature will be discussed in the following chapters.

<sup>103</sup> *The Holy Quran*, 5:2.

Prophet Muhammad (PBUH) said

عَنْ أَبِي هُرَيْرَةَ عَنِ النَّبِيِّ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ قَالَ مَنْ نَفَسَ عَنْ مُسْلِمٍ كُرْبَةً مِنْ كُرْبِ الدُّنْيَا نَفَسَ اللَّهُ عَنْهُ كُرْبَةً مِنْ كُرْبِ يَوْمِ الْقِيَامَةِ وَمَنْ يَسِّرَ عَلَى مُعْسِرٍ فِي الدُّنْيَا يَسِّرَ اللَّهُ عَلَيْهِ فِي الدُّنْيَا وَالْآخِرَةِ ... وَاللَّهُ فِي عَوْنِ الْعَبْدِ مَا كَانَ الْعَبْدُ فِي عَوْنِ أَخِيهِ

*Abu Huraira (RA) reported that the Prophet (PBUH) said ‘who removes a difficulty out of a Muslim’s worldly difficulties then Allah will remove from him a difficulty of the difficulties on the day of resurrection and if anyone makes it easy for a hard-pressed in this world then Allah will make it easy for him in this world and the next... Indeed, Allah continues to help the slave as long as the slave continues to help his brother.’<sup>104</sup>*

Following this theory of cooperation, Islam has approved some pre-Islamic systems into Islam. One of them, Aqila, is said to be akin to an insurance policy.<sup>105</sup> Under this policy, all the members of a family or tribe mutually pooled their resources to ransom a member of a family who had committed a murder. This policy used to be practiced in pre-Islamic era,<sup>106</sup> and was applied by Prophet Muhammad (PBUH) as narrated by Abu Hurairah (RA)

اقتتلت امرأتان من هذيل فرمت إداهما الأخرى بحجر فقتلتها وما في بطنها. فاختموا إلى النبس فقض أن دية جنينها غرة عبد أو وليدة وقض دية المرأة على عاقلتها –

*Once two women from the tribe of Huzail clashed when one of them hit the other with stone, which killed her and also the foetus in the victim’s womb. The heirs of the victim brought an action to the court of Holy Prophet (PBUH), who gave a verdict that the compensation for the infanticide is freeing of a male or female slave while the compensation for the killing the woman is the blood money (diyat), which to be paid by the ‘Aqilah’ of the accused.’<sup>107</sup>*

The application of this policy can also be found in 622 AD in the first constitution of Madinah, Article 4 of which read

<sup>104</sup> Sunan At-Tirmidhi, كتاب البر والصلة ت عن رسول الله صلى الله عليه وسلم, باب ما جاء فس الستر على, المسلم 1930; Abu'l-Husain 'Asakir-ud-Din Muslim b. Hajjaj al-Qushayri al-Naisaburi, Sahih Muslim, كتاب الذكر والتوبة والاستغفار, باب فضل الاجتماع على تلاوة وعلى الذكر 2699.

<sup>105</sup> Sayed Khalid Rashid, ‘Islamization of Insurance – A Religio-Legal Experiment in Malaysia’ (1993) II (1) Religion and Law Review 16, 17; Mohammed Obaidullah, Islamic Financial Services, (an e-book <<http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html>>) 35-36 accessed 2<sup>nd</sup> November 2011; Dr. Mohd. Ma’sum Billah, Islamic and Modern Insurance Principles and Practices (Ilmiah Publishers, Malaysia, 2003) 4-5.

<sup>106</sup> Before 610 A.C.

<sup>107</sup> Muhammad bin Ismail Al-Mughirah Al-Bukhari, Sahih Bukhari (Dr. M Muhsin Khan tr) Vol. 9. Kitab al-Diyat, No. 45, p. 34.

المهاجرون من قريش على ربعتهم يتعاقلون بينهم

*The immigrants among Quraish shall be responsible for their word and shall pay their blood money in mutual collaboration (i.e. by Aqila).*<sup>108</sup>

Insurance practices can also be found in business relationships in both pre-Islamic and post-Islamic eras. Makkan merchants used to form a fund to help the victims or survivors of natural hazards or disasters during their trading journeys to Syria, Iraq and other countries. In one occasion, when Muhammad (PBUH) was engaged in trade in Makkah, a whole trading caravan, apart from a few survivors, was lost in the desert. The managing board, composed of the members of the contributory fund, decided to pay the price of the merchandise, including the value of camels and horses destroyed, to the survivors and families of those who perished in the disaster out of the common fund. Muhammad (PBUH) had also contributed to that fund from his profits.<sup>109</sup>

The practice of insurance through mutual cooperation continued sparingly and no further development was made either in its operational capacity or its legal structure.<sup>110</sup> In the 19<sup>th</sup> Century, Islamic Arabs came into closer contact with the Western concept of insurance because of trading relationships, Islamic scholars then found it necessary to provide the Islamic view regarding such transactions. Ibn Abidin is the first scholar who discussed such insurance, its meaning and its legal character.<sup>111</sup> He wrote,

It was customary that if traders wanted to hire a boat from a non-Muslim owner, they made their payment of rent to that man, as well as depositing a certain amount of money with another non-Muslim agent who lived elsewhere on Islamic territory. They used to call that deposit the 'sowkra' which was proposed against all kinds of risks that might occur to the boat or its contents during the journey, such as fire, sinking or piracy, etc. the agent was paid for his services as a warrantor and his appointed proxy, who lived in the coastal area of Islamic territory, collected the Sawkara from the traders, with permission from the Sultan, and accordingly repaid them the equivalent of

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<sup>108</sup> 'Selected Articles from the Constitution of Islamic State of Madinah' <<http://www.theiceproject.sdsa.net/uploaded/files/Constitution.pdf>> accessed 7 June 2011; See also, 'مكتبة حقوق الإنسان' <<http://www1.umn.edu/humanrts/arab/IS-1.html>> accessed 2nd November 2011.

<sup>109</sup> Afzal-ur-Rahman, *Banking and Insurance: Economic Doctrines of Islam*, (Muslim Schools Trust London 1979) Vol. IV, 32.

<sup>110</sup> See, Dr. Mohd. Ma'sum Billah, *Islamic and Modern Insurance Principles and Practices* (Ilmiah Publishers, Malaysia, 2003) 8.

<sup>111</sup> E. Klingmuller 'The Concept and Development of Insurance in Islamic Countries' (January 1969) *Islamic Culture* 27, 30.



the damage done to their goods at sea, if any'.<sup>112</sup>

Ibn Abidin was of the view that such transactions were void under the Shariah since they were based on the guarantee of an uncontrollable event. Consequently, no Muslim was allowed to practice it in the Islamic territory unless the contract was totally compatible with the revelation and teachings of Islam.<sup>113</sup> However, he gave the view that a Muslim traveling to a non-Islamic country can enter into a valid insurance contract, in accordance with the law of that country,<sup>114</sup> unless and until they do not contradict the Shariah principles.<sup>115</sup> Subsequently the Ottoman Maritime Code of 1863 and the Ottoman Law of Insurance 1874 gave statutory shape to the marine and non-life insurance respectively.<sup>116</sup> In this period life insurance used to be treated as prohibited in Islam.<sup>117</sup>

Muhammad Abduh is the second scholar who, about one century after Ibn Abidin, discussed the legal issue of insurance in an Islamic view and took 'a series of attempts to insert the phenomenon insurance into the existing scheme of permitted types of legal contracts developed by Islamic law in order to free insurance from the odium of gambling and the hazardous contract and to prove its legality'.<sup>118</sup> He also approved the legality of life insurance in Islam.<sup>119</sup> In 1985, the Grand Counsel of Islamic scholars in Makkah, Majma al-Fiqh, Saudi Arabia, approved the Takaful system, including life insurance, as an alternative form of insurance, written in compliance with Shariah principles.<sup>120</sup>

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<sup>112</sup> *Radd al-Muhtar, Bab al-Musta'min*, Vol. 3 p. 345.

<sup>113</sup> See, Aly Khorshid, *Islamic Insurance A Modern Approach to Islamic Banking* (Routledge 2004) 13; E. Klingmuller 'The Concept and Development of Insurance in Islamic Countries' (January 1969) *Islamic Culture* 27, 35.

<sup>114</sup> See, E. Klingmuller 'The Concept and Development of Insurance in Islamic Countries' (January 1969) *Islamic Culture* 27, 30.

<sup>115</sup> See, *ibid* 30-31.

<sup>116</sup> See, Syed Khalid Rashid, 'Islamization of Insurance – A Religio-Legal Experiment in Malaysia' (1993) II (1) *Religion and Law Review* 16, 18; 'the first provision concerning insurance was made in section 29 of the Turkish Commercial Code dated May 3, 1860' which only stated that dispute resulted from shipping trade and marine insurance matters shall be decided by naval courts. 'Further details on marine insurance can be found in Part II of the Act on Shipping Trade of August 18, 1863, which, in fact, is practically a translation of the French Act on Shipping Trade of 1808.' E. Klingmuller 'The Concept and Development of Insurance in Islamic Countries' (January 1969) *Islamic Culture* 27, 33.

<sup>117</sup> Professor Samir Mankabady, 'Insurance and Islamic Law, the Islamic Insurance Company' (1989) *Arab Law Quarterly* 199, 201.

<sup>118</sup> See, E. Klingmuller 'The Concept and Development of Insurance in Islamic Countries' (January 1969) *Islamic Culture* 27, 34.

<sup>119</sup> El-Sanhuri, *Civil Law*, vol. 7, 1964, p. 1088; See, Professor Samir Mankabady, 'Insurance and Islamic Law, the Islamic Insurance Company' (1989) *Arab Law Quarterly* 199, 201.

<sup>120</sup> Grand Counsel of Islamic scholars, in Makkah, Majma al-Fiqh, Saudi Arabia 'The Grand Counsel Letter' (2<sup>nd</sup> edition, 1985).

## 2.5 Legal Sources of Islamic Insurance

Shariah principles derive from four sources. The sources are defined in the following verse of the Quran,

يَا أَيُّهَا الَّذِينَ آمَنُوا أَطِيعُوا اللَّهَ وَأَطِيعُوا الرَّسُولَ وَأُولِي الْأَمْرِ مِنْكُمْ فَإِنْ تَنَازَعْتُمْ فِي شَيْءٍ فَرُدُّوهُ إِلَى اللَّهِ وَالرَّسُولِ إِنْ كُنْتُمْ تُؤْمِنُونَ بِاللَّهِ وَالْيَوْمِ الْآخِرِ ذَلِكَ خَيْرٌ وَأَحْسَنُ تَأْوِيلًا

*O you who have believed, obey Allah and obey the Messenger and those in authority among you. And if you disagree over anything, refer it to Allah and the Messenger, if you should believe in Allah and the Last Day. That is the best [way] and best in result.*<sup>121</sup>

In this verse, the words ‘obey Allah’ refer to Quran and ‘obey the Messenger’ refer to the Sunnah (Hadith).<sup>122</sup> ‘Obedience to ‘those who are in charge of affairs’ is held to be a reference to ijma’ and the order of referring the disputed matters to Allah and the Messenger ‘authorises qiyas’.<sup>123</sup> It is apparent from this verse of the Quran that the four sources of Islamic law are: Quran, Hadith, Ijma and Qiyas. Out of these four sources the first three sources are primary and the fourth one is secondary.<sup>124</sup> The priority of these sources are also explained in the following Hadith

عَنْ أَنَسٍ مِنْ أَهْلِ حِمْصَ مِنْ أَصْحَابِ مُعَاذِ بْنِ جَبَلٍ أَنَّ رَسُولَ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ لَمَّا أَرَادَ أَنْ يَبْعَثَ مُعَاذًا إِلَى الْيَمَنِ قَالَ كَيْفَ تَقْضِي إِذَا عَرَضَ لَكَ قَضَاءٌ قَالَ أَقْضِي بِكِتَابِ اللَّهِ قَالَ فَإِنْ لَمْ تَجِدْ فِي كِتَابِ اللَّهِ قَالَ فَبِسُنَّةِ رَسُولِ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ قَالَ فَإِنْ لَمْ تَجِدْ فِي سُنَّةِ رَسُولِ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ وَلَا فِي كِتَابِ اللَّهِ قَالَ أَجْتَهُدُ رَأْيِي وَلَا أَلُو فَضْرَبَ رَسُولُ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ صَدْرَهُ وَقَالَ الْحَمْدُ لِلَّهِ الَّذِي وَفَّقَ رَسُولَ رَسُولِ اللَّهِ لِمَا يُرْضِي رَسُولَ اللَّهِ

*Anas (RA) narrated from some companions of Mu’adh ibn Jabal that ‘When the Apostle of Allah (PBUH) intended to send Mu’adh ibn Jabal to the Yemen, He asked: How will you judge when the occasion of deciding a case arises? He replied: I shall judge in accordance with Allah’s Book. He asked: (What will you do) if you do not find any guidance in Allah’s Book? He replied: (I shall act) in accordance with the Sunnah of the Apostle of Allah (PBUH) He asked: (What will you do) if you do not find any guidance in the Sunnah of the Apostle of Allah (PBUH) and in Allah’s Book? He replied: I shall do my best to form*

<sup>121</sup> The Holy Quran, 4:59.

<sup>122</sup> Sunnah is the acts or rules of Prophet Muhammad (PBUH) and Hadith is their narration. Both of these terms will be used following the demand of particular sentence.

<sup>123</sup> Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence* (Revised Edition, Islamic texts society, Cambridge, 1991) 10.

<sup>124</sup> See, Imran Ahsan Khan Nyazee, *Islamic Jurisprudence* (1<sup>st</sup> edn, International Institute of Islamic Thought and Islamic Research Institute, Islamabad, 2000) 150.

*an opinion and I shall spare no effort. The Apostle of Allah (PBUH) then patted him on the breast and said: Praise be to Allah Who has helped the messenger of the Apostle of Allah to find something which pleases the Apostle of Allah.*<sup>125</sup>

According to this Hadith, the Quran is the highest priority, with Hadith,<sup>126</sup> the Ijma and the Qiyas following in that order.

### 2.5.1 Quran

The Quran consists only the words of Allah (SWT). This is the first and principal source of Islamic law. There are 114 Suras (chapters) and 6235 verses in the Quran. Its language is Arabic, as Allah (SWT) says:

إنا أنزلناه قرآنا عربيا

*Verily, We have sent it down as an Arabic Quran.*<sup>127</sup>

The Quran was revealed gradually to Prophet Muhammad (PBUH) in parts over twenty-three years in accordance with incidents faced by the Muslim community.<sup>128</sup> The Prophet (PBUH) used to memorise the verses revealed to him and then recited them to his companions who also used to memorise them. There were also scribes with the Prophet (PBUH) who used to record the verses after their revelation and recitation. These written records were then preserved in the Prophet's house. The angel Jibril, who used to transmit the verses to the Prophet (PBUH) from Allah (SWT), used to inform the Prophet (PBUH) of the place and location of each verse within its chapter. Jibril used to read once every year all of what had been revealed to the Prophet (PBUH) from the Quran. In the last year of the Prophet's (PBUH) life Jibril (AS), recited the whole Quran in its proper arrangement and the Prophet (PBUH) recited it twice after him.<sup>129</sup> By the time of first Caliph Abu Bakr the Quran was to

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<sup>125</sup> Sunan Abu-Daud, كتاب الاقضية, باب اجتهاد الرأي في الاقضاء, 3592

<sup>126</sup> See also, the instruction given by Umar ibn al Khattab (R.A) sending a letter to qadi Shurayh stating that 'When you are faced with an issue, decide through what is laid down in the Book of Allah. If the issue you face relates to what is not in the Book of Allah, then decide by what is in the Sunnah of the Messenger of Allah (PBUH).' This Hadith is cited by Imran Ahsan Khan Nyazee, *Islamic Jurisprudence* (1<sup>st</sup> edn, International Institute of Islamic Thought and Islamic Research Institute, Islamabad, 2000) 151.

<sup>127</sup> *The Holy Quran*, 12:2..

<sup>128</sup> ibid 17:106.

<sup>129</sup> It has been narrated by Abu Hurayra (ra.) that he said:

كان يعرض على النبي صلى الله عليه وسلم القرآن كل عام مرة فعرض عليه مرتين في العام الذي قبض فيه

Jibril used to present the Quran to the Prophet once a year, but he presented it twice to him in the year he died. (Bukhari)

be found in its complete form either memorised or recorded in *suhuf* (loose pieces of writing material, such as skin, papyrus or paper).<sup>130</sup>

It is to be noted that Quran is not a legal or a constitutional document. The Quran calls itself *huda*, or guidance.<sup>131</sup> One-tenth of its verses relate to law and jurisprudence and the rest are largely concerned with matters of belief and morality, the five pillars of the faith and a variety of other themes. Some of these legal verses were revealed to repeal objectionable customs such as infanticide, usury, gambling and unlimited polygamy. Others laid down penalties with which to enforce the reforms that the Quran had introduced. An estimated 140 verses relate to devotional matters such as *salah*, *zakah* (legal charity), *siyam* (fasting), the Pilgrimage of *hajj*, *jihad*, charities, the taking of oaths and penances. Another seventy verses relate to marriage, divorce, revocation, dower, maintenance, custody of children, fosterage, paternity, inheritance and bequest. Another seventy verses relate to commercial transactions. There are about thirty verses on crimes and penalties. Another thirty verses are on justice, equality, evidence, consultation and the right and obligations of citizens. There are about ten verses that relate to economic matters.<sup>132</sup>

The rules of the Quran are divided into two parts: a) definitive; b) speculative as Allah (SWT) says in the Quran

هو الذي أنزل عليك الكتاب منه آيات محكمات هن أم الكتاب وأخر متشابهات

*In it are Verses that are entirely clear, they are the foundations of the Book; and others not entirely clear.*<sup>133</sup>

The example of definitive verse is:

وأحل الله البيع وحرم الربا

*Allah has permitted trading and forbidden usury.*<sup>134</sup>

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<sup>130</sup> See, Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence* (Revised Edition, Islamic texts society, Cambridge, 1991) 17; Imran Ahsan Khan Nyazee, *Islamic Jurisprudence* (1<sup>st</sup> edn, International Institute of Islamic Thought and Islamic Research Institute, Islamabad, 2000) 159.

<sup>131</sup> See, *The Holy Quran*, 2:2.

<sup>132</sup> Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence* (Revised Edition, Islamic texts society, Cambridge, 1991) 20. It is to be noted that, the scholars are not in agreement over these figures, as calculations of this nature tend to differ according to one's understanding of, and approach to, the contents of the Quran.

<sup>133</sup> *The Holy Quran*, 3:7

<sup>134</sup> *ibid* 2:275.

The example of speculative verse is:

وامسحوا برءوسكم

*Wipe over your head with water.*<sup>135</sup>

The second verse does not make it clear whether the full or part of the head should be wiped. These speculative verses are required to be interpreted following Hadith. The majority of verses that relate to civil transactions and property are not specific or detailed, leaving the scholars to research these matters following Hadith and surrounding circumstances. For example, the Quran has given the general guideline of trading saying that ‘O you who have believed, do not consume one another’s wealth unjustly but only [in lawful] business by mutual consent’.<sup>136</sup> The Quran has not provided the detailed varieties of lawful trade and the forms of unlawful interference with the property of others. Some of these have been explained and elaborated by the Hadith. ‘As for the rest, it is for the scholars and the mujtahidun [researchers] of every age to specify them in the light of the general principles of the Shariah and the needs and interests of the people’.<sup>137</sup> Similarly the Quran commands to do justice but no detailed duties are provided. It is, therefore, for the government and scholars to decide what act should be fair in the given circumstances.

The reason for not providing detail and specific rules is laid down in the Quran:

يأيتها الذين ءامنوا لاتسألوا عن أشياء إن تبدلكنم تسؤكنم

*O you who have believed, do not ask about things which, if they are shown to you, will distress you.*<sup>138</sup>

In another verse Allah says

يريد الله بكم اليسر ولا يريد بكم العسر

*Allah intends for you ease and does not intend for you hardship.*<sup>139</sup>

It is evident that Allah (SWT) does not want to provide unbearable burden on Muslims by imposing specific rules and as such left some room for the rules to be researched and a

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<sup>135</sup> ibid 5:6.

<sup>136</sup> ibid 4:29.

<sup>137</sup> Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence* (Revised Edition, Islamic texts society, Cambridge, 1991) 30.

<sup>138</sup> *The Holy Quran*, 5:101.

<sup>139</sup> ibid 2:185.

solution reached that suits the circumstances. However, He has created a boundary through the general guidance which cannot be violated in any circumstances.

### 2.5.2 Sunnah

The literal meaning of Sunnah is ‘well known path’ which is followed again and again. In Islamic law it is defined as ‘what was transmitted from the Messenger of Allah (PBUH) of his words, acts and (tacit) approvals’.<sup>140</sup> Accordingly, Sunnah is divided into three parts,

- Qawli i.e. verbal which consists of the sayings of the Prophet (PBUH).
- Fi’li i.e. actual – this consists of his deeds and actual instruction.
- Taqriri i.e. tacitly approved – this consists of the acts and sayings of the Companions which came to the knowledge of the Prophet and he approved them either expressly or being silent showing lack of disapproval.<sup>141</sup>

Sunnah provides following categories of rules,<sup>142</sup>

- Fard (obligatory) – for example, the method of praying the Salah is established from the Sunnah and not the Quran. The Quran issues the command to pray only.
- Haram (prohibition) – for example, Sunnah established the fasting on the day of Eid as Haram.
- Mandub (recommended act) – for example, fasting on Monday is Mandub and is established by Sunnah.
- Makruh (disliked act) – for example, eating garlic before going to mosque is Makruh and is established by Sunnah.
- Mubah (permitted act) – for example, at time Prophet (PBUH) drank water sitting or standing.

Out of these five categories of rules the first two, fard and haram, must be followed,<sup>143</sup> because Sunnah is also a primary source of Islamic law as Prophet Muhammad (PBUH) said

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<sup>140</sup> Imran Ahsan Khan Nyazee, *Islamic Jurisprudence* (1<sup>st</sup> edn, International Institute of Islamic Thought and Islamic Research Institute, Islamabad, 2000) 162 – 163.

<sup>141</sup> See, Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence* (Revised Edition, Islamic texts society, Cambridge, 1991) 50-51; Imran Ahsan Khan Nyazee, *Islamic Jurisprudence* (1<sup>st</sup> edn, International Institute of Islamic Thought and Islamic Research Institute, Islamabad, 2000) 163-168.

<sup>142</sup> See, Abu Tariq Hilal and Abu Ismael al-Beirawi, *Understanding Usul Al-Fiqh (Principles of Islamic Jurisprudence)* (Revival Publications, New Delhi, 2007) 57-58.

<sup>143</sup> See, *ibid* 62-65.

تركت فيكم أمرين لن تضلوا ما تمسكتم بهما كتاب الله وسنة نبيه

*I left two things among you. You shall not go astray so long as you hold on to them. These are the book of Allah (Qur'an) and the Sunnah of His Messenger.*<sup>144</sup>

Allah (SWT) says

من يطع الرسول فقد أطاع الله

*He who obeys the Messenger has obeyed Allah.*<sup>145</sup>

In another verse Allah (SWT) says

وما كان لمؤمن ولا مؤمنة إذا قضى الله ورسوله أمرا أن يكون لهم الخيرة من أمرهم ومن يعص الله ورسوله فقد ضللا مبيها

*It is not for a believing man or a believing woman, when Allah and His Messenger have decided a matter, that they should [thereafter] have any choice about their affair. And whoever disobeys Allah and His Messenger has certainly strayed into clear error.*<sup>146</sup>

The third category of the rule, mandub, is the recommendation to do and the fourth, makruh suggests not to do something. Both of these rules are voluntary and there is no serious harm in breaching them but it is highly recommended to follow them. The fifth category of Sunnah, Mubah, provides permission to do something. There is no reward nor harm for doing it or not doing it.<sup>147</sup> These categories of Sunan (plural of Sunnah) are created following the nature of emphasis given by the Prophet (PBUH) on the particular act.<sup>148</sup>

### 2.5.3 Ijma

'Ijma' is an Arabic word meaning unanimity or unanimous agreement. In Islamic law it is defined as

إتفاق المجتهدين من أمة محمد صلى الله عليه وسلم بعد وفاته في عصر من العصور على حكم شرعي

<sup>144</sup> Imam Malik, *Al-Muatta*, 1661 كتاب الجامع. باب القدر

<sup>145</sup> *The Holy Quran*, 4:80.

<sup>146</sup> *ibid* 33:36. See also *The Holy Qur'an* 4:65.

<sup>147</sup> See, Imran Ahsan Khan Nyazee, *Islamic Jurisprudence* (1<sup>st</sup> edn, International Institute of Islamic Thought and Islamic Research Institute, Islamabad, 2000) 65 – 67, 72.

<sup>148</sup> See, Abu Tariq Hilal and Abu Ismael al-Beirawi, *Understanding Usul Al-Fiqh (Principles of Islamic Jurisprudence)* (Revival Publications, New Delhi, 2007) 62-66. Hashim Kamali, *Principles of Islamic Jurisprudence* (Revised Edition, Islamic texts society, Cambridge, 1991) 53.

*The consensus of mujtahids (independent jurists) from the ummah of Muhammad (PBUH), after his death, in a determined period upon a rule of Islamic law.*<sup>149</sup>

There are seven conditions derive from this definition which must be satisfied for a valid ijma. These are,

- the agreement or consensus must take place among mujtahids,
- the agreement must be unanimous among all the mujtahids,
- all the jurists participating in ijma must be from the ummah (nation) of Muhammad (PBUH),
- the agreement must have taken place after the death of the Prophet (PBUH),
- the agreement must be among the mujtahids of a single determined period,
- the agreement must be upon a rule of law,
- the mujtahids should have relied upon a sanad (an evidence in one of the first two sources of law) for deriving their opinion.<sup>150</sup>

A valid ijma is a binding authority.<sup>151</sup> In evidence the following Ahadith can be referred. Prophet (S.A.W) said ‘Allah has protected you from three things...you should not all agree in an error’.<sup>152</sup> The Holy Prophet (PBUH) also said ‘Allah will never allow my Ummah to unite upon misguidance and incorrect beliefs. Allah’s mercy, blessings and protection are with the largest group of Muslims. And he who deviates from this largest group of Muslims will be thrown into Hell.’<sup>153</sup> Imam Shafi’i (Rahimahullah) stated in al-Rasala,

Umar ibn al-Khattab (Allah be pleased with him) made a speech at al-Jabiya in which he said: The Apostle of Allah (Peace be upon him) stood among us by an order from Allah, as I am now standing among you, and said: Believe my Companions, then those who succeed them (the Successors), and after that those who succeed the Successors; but after them untruthfulness will prevail when people will swear (in support of their saying) without having been asked to swear, and will testify without having been asked to testify. Only those who seek the pleasure of Paradise will follow the community, for the devil can pursue one person but stands far away from two.<sup>154</sup>

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<sup>149</sup> This is a generally accepted definition and cited by Imran Ahsan Khan Nyazee, *Islamic Jurisprudence* (1<sup>st</sup> edn, International Institute of Islamic Thought and Islamic Research Institute, Islamabad, 2000)183. See also Dr. Rohi Baalbaki, *Al-Mawrid Arabic-English dictionary* (Dar El-ilm Lilmalayin, 5<sup>th</sup> edn, 1993) 41.

<sup>150</sup> See, Imran Ahsan Khan Nyazee, *Islamic Jurisprudence* (1<sup>st</sup> edn, International Institute of Islamic Thought and Islamic Research Institute, Islamabad, 2000) 183 – 185.

<sup>151</sup> Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence* (Revised Edition, Islamic texts society, Cambridge, 1991) 168-169.

<sup>152</sup> *Sunan Abu-Dawud*, Book 35, No. 4240

<sup>153</sup> Imaam Abi 'Eesaa Muhammad bin 'Eesah bin Sorah At-Tirmidhi, *Sahih Tirmidi* Vol 2, p. 39.

<sup>154</sup> (p. 286-87), see also *Musnad Abu Daud*.



An example of ijma. The sunnah (in the category of Mandub) is that the dead should be buried quickly and it is forbidden for those responsible for the burial to delay the burial on account of other things. Yet when the Prophet (PBUH) died, the Companions delayed His (PBUH) burial until they had selected a Khaleefah (governor) from among themselves. None of the companions objected to the delay for the reason of selecting Khaleefah. Consequently, it has become a rule of ijma that appointment of Khaleefah is more important than the burial of Khaleefa who has just died.<sup>155</sup> However, scholars argue that creating a new rule fulfilling the conditions of ijma is now nearly impossible as the Muslim world is composed a large number of states.<sup>156</sup>

#### 2.5.4 Qiyas

Qiyas is an Arabic word meaning measurement. In Islamic law, Qiyas means ‘juristic reasoning (inference, deduction) by analogy’.<sup>157</sup> It applies to ‘the assignment of the *hukm* [rule] of an existing case found in the texts of the Quran, the Sunnah, or ijma to a new case whose *hukm* is not found in these sources on the basis of a common underlying attribute’.<sup>158</sup> There are four elements of Qiyas that derives from this definition. Firstly, the original case, *asl*, on which a ruling is given in the text. Then there is a new case on which a ruling is being looked for, and this is called *far*. The ‘the effective cause, *illah*, which is an attribute of the *asl* and is found to be in common between the original and the new case’. Finally, the rule, *hukm*, governing the original case is extended to the new case.<sup>159</sup>

#### *Examples of Qiyas*

The Prophet is reported to have said that ‘the killer shall not inherit’. Subsequently the question arose regarding the bequest whilst the Hadith only referred to inheritance. Here, the *asl* is killing the predecessor; *far* is killing the testator; *illah* is obtaining the benefit by way of

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<sup>155</sup> See, Abu Tariq Hilal and Abu Ismael al-Beirawi, *Understanding Usul Al-Fiqh (Principles of Islamic Jurisprudence)* (Revival Publications, New Delhi, 2007) 77-78.

<sup>156</sup> See, Imran Ahsan Khan Nyazee, *Islamic Jurisprudence* (1<sup>st</sup> edn, International Institute of Islamic Thought and Islamic Research Institute, Islamabad, 2000) 192-193; Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence* (Revised Edition, Islamic texts society, Cambridge, 1991) 184.

<sup>157</sup> See Dr. Rohi Baalbaki, *Al-Mawrid Arabic-English dictionary* (5<sup>th</sup> edn, Dar El-ilm Lilmalayin, 1993) 878.

<sup>158</sup> This is a definition of *Qiyas* given by jurists, cited by Imran Ahsan Khan Nyazee, *Islamic Jurisprudence* (1<sup>st</sup> edn, International Institute of Islamic Thought and Islamic Research Institute, Islamabad, 2000) 214.

<sup>159</sup> See, Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence* (Revised Edition, Islamic texts society, Cambridge, 1991) 200.

murder; consequently, the *hukm*, the deprivation from the benefit governing the original case shall be extended to the new case regarding the bequest.

Allah (SWT) forbids selling or buying goods after the last call for Friday prayer until the end of the prayer.<sup>160</sup> Here, the underlying cause is reducing the incentive to offer the Friday prayer. Pledging or marriage may also cause the same result and as such the rule, *hukm*, can be extended to these transactions.

Another example of Qiyas which was shown by the Prophet Muhammad (PBUH) when he was asked by a companion that ‘O Messenger of Allah, my father has died and he did not perform Hajj (pilgrimage); shall I perform Hajj on his behalf?’ He said ‘Do not you think that if your father owed a debt you would pay it off?’ The man said ‘Yes’, He said ‘the debt owed to Allah is more deserving (of being paid off)’.<sup>161</sup> Here he extended the rule of paying debt of the deceased by a relative to performing the obligatory Hajj by the relative.

In this modern era, many things have been invented which were not present during the period of the Prophet (PBUH). Consequently, there is no specific rule can be found in relation to these new inventions. However, the chance of creating new laws through ijma is very low in this modern era due to the large number of states in the Muslim world.<sup>162</sup> In such circumstances, scholars principally rely on the fourth source, Qiyas, when deciding the rules related to new inventions. One of these new inventions is the modern structure of insurance policies. In order to create the rules and structure of modern Islamic insurance policies, the scholars relied on the fourth source ensuring that their newly created rules or structures do not breach the following principal guidelines provided by the first two sources of the law.

## **2.6 Shariah Principles That Shape the Structures of Islamic Insurance Policy**

Shariah principles have given precise guidelines for business transactions. If any of these guidelines are violated the transaction shall not be valid. The following guidelines actively affect an insurance contract.<sup>163</sup>

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<sup>160</sup> *The Holy Quran*, 62:9.

<sup>161</sup> Imam Nasai, *Sunan an-Nasai* 2639; English Translation: Vol 1, Book 24, Hadith 2640.

<sup>162</sup> See, Imran Ahsan Khan Nyazee, *Islamic Jurisprudence* (1<sup>st</sup> edn, International Institute of Islamic Thought and Islamic Research Institute, Islamabad, 2000) 192-193; Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence* (Revised Edition, Islamic texts society, Cambridge, 1991) 184.

<sup>163</sup> The guidelines are analysed following the Islamic concepts only since other legal explanation of certain term, e.g. English legal concepts, will not be accepted if that contradicts with the Islamic principles.

### 2.6.1 Riba (usury)

The literal meaning of Riba or usury is an increase in or an addition to something.<sup>164</sup> The definition of the word is ‘an addition to the principal of a loan, usually interpreted as interest payments or receipts for both commercial and private loans’.<sup>165</sup> In the Islamic view it is an ‘unjustifiable increase in capital for which no compensation is given’.<sup>166</sup>

Usury is strictly prohibited by both Quran and Hadith. Allah (SWT) seriously condemned usury in different places of the Qur’an. As He says:

الذين يأكلون الربوا لا يقومون إلا كما يقومون الذي يتخبطه الشيطان من المس- ذلك بأنهم قالوا إنما البيع مثل الربوا وأحل الله البيع وحرم الربوا...

*Those who consume interest i.e. usury cannot stand [on the Day of Resurrection] except as one stands who is being beaten by Satan into insanity. That is because they say, ‘Trade is [just] like interest.’ But Allah has permitted trade and has forbidden interest...<sup>167</sup>*

He then says:

يمحق الله الربوا ويرس الصدقت- والله لا يحب كل كفار أثيم

*Allah destroys interest and gives increase for charities. And Allah does not like every sinning disbeliever.<sup>168</sup>*

Prophet Muhammad (PBUH) said in his last sermon that ‘Every form of riba (usuary) is cancelled.’<sup>169</sup> Allah (SWT) condemned the ‘debt usury’ and the Prophet (PBUH) mainly condemned the ‘sale usury’.<sup>170</sup> For example, Malik b. Aus b. al-Hadathan reported:

I came saying who was prepared to exchange dirhams (for my gold), whereupon Talha b. Ubaidullah (Allah be pleased with him) (as he was sitting with 'Umar b. Khattib) said: Show us your gold and then come to us (at a later time). When our

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<sup>164</sup> Afzal-ur-Rahman, *Banking and Insurance: Economic Doctrines of Islam* (Muslim Schools Trust London 1979) Vol. IV, 112.

<sup>165</sup> Wilson 1987.

<sup>166</sup> Aly Khorshid, *Islamic Insurance A Modern Approach to Islamic Banking* (Routledge 2004) 32.

<sup>167</sup> *The Holy Quran*, 2: 275.

<sup>168</sup> *ibid* 2: 276; see also *The Holy Quran*, 3:130, 30:39.

<sup>169</sup> *Tafsir Al- Khazin*, vol.1, p.301.

<sup>170</sup> Aly Khorshid, *Islamic Insurance A Modern Approach to Islamic Banking* (Routledge 2004) 34. However, ‘debt usury’ was mentioned in Hadith which merely enforced the Quranic injunction against riba and outlined the detail exactly what is banned.

servant would come we would give you your silver (dirhams due to you). Thereupon 'Umar b. al-Khattib (Allah be pleased with him) said: Not at all. By Allah, either give him his silver (coins). or return his gold to him, for Allah's Messenger (may peace be upon him) said: Exchange of silver for gold (has an element of) interest in it. except when (it is exchanged) on the spot; and wheat for wheat is an interest unless both are handed over on the spot: barley for barley is interest unless both are handed over on the spot; dates for dates is interest unless both are handed over on the Spot.<sup>171</sup>

### 2.6.2 Gharar (uncertainty)

Gharar is an Arabic word means risk, uncertainty, and hazard. It is broadly defined by the Islamic scholars in two ways. Firstly, it implies uncertainty, as the Prophet Mohammad (PBUH) 'forbade the sale with uncertainty in it'.<sup>172</sup> Or, it implies deceit, as Allah (SWT) said in the Quran:

ويل للمطففين. الذين إذا اكتالوا على الناس يستوفون. وإذا كالوهم أو وزنوهم يخسرون

*Woe to those who give less [than due], who, when they take a measure from people, take in fully. But if they give by measure or by weight to them, they cause loss.*<sup>173</sup>

Four categories of Gharar have been identified by Mohammad Hashim Kamali, considering the views of Islamic scholars.<sup>174</sup> The first category, is 'uncertainty over the actual existence of something at the time of contract.' such as, the sale of stray animal or the young still unborn calf whilst the mother is not part of the sale. Ibn Abbas reported from Allah's Messenger (S.A.W) that He said: 'He who buys food grain should not sell it until he has taken possession of it.' Ibn Abbas said: 'I regard everything as food (so far as this principle is concerned)'.<sup>175</sup> Secondly, when the goods exist but the 'uncertainty surrounds over its availability at the time of contract'. For example, fish in the lake. The third type of uncertainty is 'uncertainty over quantity either of the subject matter or its price, or both'. Such as, the vendor saying the buyer: 'I sell you a piece of cloth which is at my home'. The remaining 'uncertainty is over the timing of completion and delivery'. For example, an offer

<sup>171</sup> A A Muslim *Sahih Muslim* (Arabic Reference) Book 23, Hadith 4143, (USC Centre for Muslim-Jewish Engagement tr, < <http://www.usc.edu/org/cmje/religious-texts/hadith/muslim/010-smt.php> >) Book 10, Hadith 3850 accessed 05/07/2013.

<sup>172</sup> Imam Malik *Al-Muwatta* (USC Centre for Muslim-Jewish Engagement tr, <<http://www.usc.edu/org/cmje/religious-texts/hadith/muwatta/032-mmt.php>>) Book 31, Hadith 31.34.75 accessed 05/07/2013.

<sup>173</sup> *The Holy Quran*, 83: 1-3; see 11: 84-86.

<sup>174</sup> Mohammad Hashim Kamali, 'Uncertainty and Risk-Taking (Gharar) in Islamic Law' (International Conference on Takaful Insurance, Kuala Lumpur, Hilton, 2<sup>nd</sup> June 1999) 199, 210.

<sup>175</sup> A. A. Muslim, *Sahih Muslim*, (USC Centre for Muslim-Jewish Engagement tr, <<http://www.usc.edu/org/cmje/religious-texts/hadith/muslim/010-smt.php>>) Book 010, Number 3642. Accessed 05/07/2013.

to sell when a stated person enters the room or when a stated person dies.

In conclusion, it could be said that Gharar in a contract is essentially related to availability of information pertaining to its possible outcomes for both parties. All parties to the contract must be sufficiently informed to make a reasonable estimate of the outcome. Islamic law always supports the informationally weaker party. For example, Prophet Mohammad (S.A.W) prohibits a sale whereby a townsman meets a tribesman outside the market place and buys the tribesman's goods at a price cheaper than the price prevailing in the market, thus taking advantage of the seller's ignorance of the market price.<sup>176</sup>

### 2.6.3 Maisir (Gambling)

Franz Rosenthal defined Gambling as a 'man's natural play instinct with his desire to know about his fate and his future'.<sup>177</sup> He submitted that it 'can be stretched to include many other concepts such as betting and wagering'.<sup>178</sup> Professor R Qaiser defined it in following terms 'Maisir means any form of business in which monetary gains come from mere chance, speculation and conjuncture and not from work or real business'.<sup>179</sup> An example of a gambling contract can be found from the text of Malik's Muwatta,<sup>180</sup>

The Messenger of Allah, may Allah bless him and grant him peace, forbade muzabana...Malik said, "... The explanation of muzabana is that it is buying something whose number, weight and measure is not known with something whose number, weight or measure is known, for instance, if a man has a stack of food whose measure is not known, either of wheat, dates, or whatever food, or the man has goods of wheat, date kernels, herbs, safflower, cotton, flax, silk, and does not know its measure or weight or number and then a buyer approaches him and proposes that he weigh or measure or count the goods, but, before he does, he specifies a certain weight, or measure, or number and guarantees to pay the price for that amount, agreeing that whatever falls short of that amount is a loss against him and whatever is in excess of that amount is a gain for him. That is not a sale. It is taking risks and it is an uncertain transaction. It falls into the category of gambling because he is not buying something from him for something definite which he pays. Everything which resembles this is also forbidden.

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<sup>176</sup> ibid Book 010, Number 3627, 3628.

<sup>177</sup> Franz Rosenthal, *Gambling in Islam* (Brill, Netherlands, 1975) 1.

<sup>178</sup> ibid 1.

<sup>179</sup> Professor R. Qaiser, 'Takaful – the Islamic Insurance' National Insurance Academy, page 3. <<http://www.niapune.com/pdfs/Research/TAKAFUL%20INSURANCE.pdf>> accessed 27 December 2012. See also, Dr Nik Ramlah Mahmood, 'Takaful: the Islamic System of Mutual Insurance – the Malaysian Experience' (1991) *Arab Law Quarterly* 280, 284.

<sup>180</sup> Malik bin Anas, *al-Muwatta*, (Arabic Reference) Book 31, Hadith 1318; (USC Centre for Muslim-Jewish Engagement tr, <<http://www.usc.edu/org/cmje/religious-texts/hadith/muwatta/032-mmt.php>>) Book 31, Hadith 31.13.25 accessed 05/07/2013.

Gambling is prohibited by Allah (SWT) as He said,

يأيتها الذين آمنوا إنما الخمر والميسر... رجس من عمل الشيطان فاجتنبوه لعلكم تفلحون

*O you who believe! Intoxicants and gambling...are an abomination of Satan's handiwork. So avoid that in order that you may be successful.*<sup>181</sup>

## **2.7 How the Modern English Insurance Policies are affected by These Shariah Principles**

It is claimed by Islamic scholars that usury exists in both English life insurance and general insurance policies. In life insurance policies the amount that is paid on death is much more than the amount received by way of premium which falls under the category of usury.<sup>182</sup> In general insurance 'the policyholder expects to obtain a fix amount of profit that is greater than what he has contributed is considered as riba'.<sup>183</sup> In both cases, the insurance funds are generally invested in instruments which are usury based.<sup>184</sup>

The element of Gharar or uncertainty exists in an English policy in the way that 'the insurer does not know whether he will ever be called upon to pay claims under the policy, nor the size of such claims, if any. Similarly the insured pays a premiums (price) but does not know if he is going to receive any financial benefit in future, nor the size of such benefit'.<sup>185</sup>

Gambling exists in English insurance policies through the expectation of a policyholder of gaining a large sum from his small amount of contributions if the peril occurs and maintaining the chance of losing premiums if no peril occurs.<sup>186</sup> Similarly an underwriter

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<sup>181</sup> *The Holy Quran*, 5: 90.

<sup>182</sup> Professor R. Qaiser, 'Takaful – the Islamic Insurance' National Insurance Academy, page 2. <<http://www.niapune.com/pdfs/Research/TAKAFUL%20INSURANCE.pdf>> last accessed 27 December 2012

<sup>183</sup> Jacky Lim, Muhammad Fahmi Idris and Yura Carissa, 'History, Progress and Future Challenge of Islamic Insurance (Takaful) in Malaysia' (Oxford Business & Economics Conference Program, St. Hugh's College, Oxford University, UK, 2010) 7.

<sup>184</sup> Kazi Md. Mortuza Ali, *Introduction to Islamic Insurance* (Islamic Foundation Bangladesh, 2006) 27.

<sup>185</sup> Mohammed Obaidullah, *Islamic Financial Services*, (an e-book <<http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html>> 2005) 123; accessed 2 November 2011. See also, Jacky Lim, Muhammad Fahmi Idris and Yura Carissa, 'History, Progress and Future Challenge of Islamic Insurance (Takaful) in Malaysia' (Oxford Business & Economics Conference Program, St. Hugh's College, Oxford University, UK, 2010) 6.

<sup>186</sup> See, Professor R. Qaiser, 'Takaful – the Islamic Insurance' National Insurance Academy, page 3. <<http://www.niapune.com/pdfs/Research/TAKAFUL%20INSURANCE.pdf>> accessed 27 December 2012.

gambles by taking the risk of losing a large sum if peril occurs and creating the chance of gaining the premiums in the absence of any peril.<sup>187</sup> However, the English insurance law has imposed the condition of ‘insurable interest’ to prevent gambling in the guise of insurance, but it has failed to completely stop such practice as certain loopholes remain due to the way this requirement is applied. These loopholes are discussed in the Chapter Three of this thesis.

## **2.8 Islamic Models of Insurance Policy**

Finding the elements usury, gambling and uncertainty in the modern conventional policies, Islamic scholars have invented different models of insurance policies taking the theme of mutual help and solidarity. These are discussed below.

### **2.8.1 Tabarru-based Takaful**

This is the basic method of Takaful and was originally used in Sudan.<sup>188</sup> This model is non-profitable. Under this policy, the promoters or the policyholders do not get any return. The initial contribution to organise the policy may come from the promoters as qard-hasan (loan without any usury). Participants donate to the takaful fund, which is used to extend financial assistance to any member in the manner defined in the agreement. Temporary shortfalls are also met through qurad hasan loans from promoters. In this model of takaful, the policyholders are the managers of the fund with ultimate control. This model is presented in Figure 1.

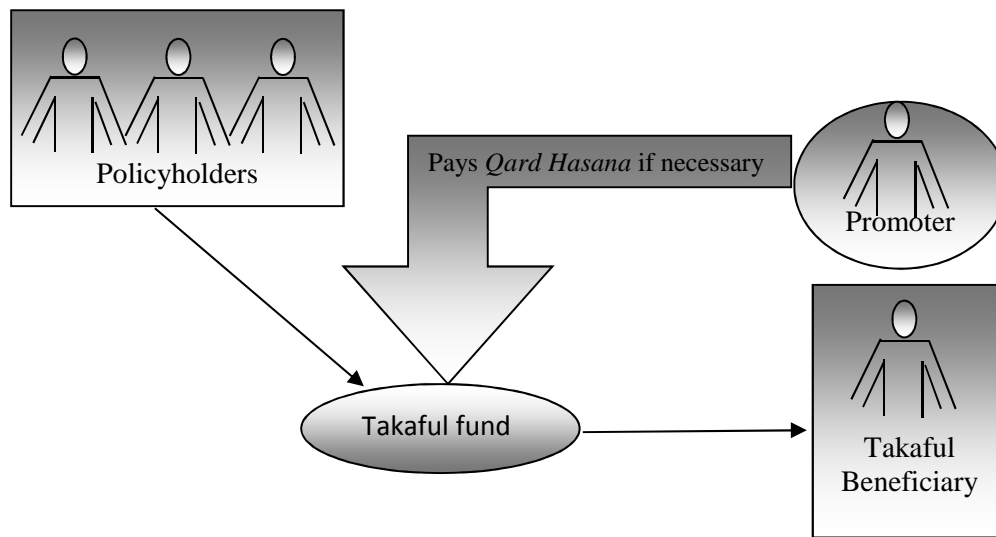
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Jacky Lim, Muhammad Fahmi Idris and Yura Carissa, ‘History, Progress and Future Challenge of Islamic Insurance (Takaful) in Malaysia’ (Oxford Business & Economics Conference Program, St. Hugh’s College, Oxford University, UK, 2010) 6. Kazi Md. Mortuza Ali, *Introduction to Islamic Insurance* (Islamic Foundation Bangladesh, 2006) 38.

<sup>187</sup> See, *ibid*, page 3. Jacky Lim, Muhammad Fahmi Idris and Yura Carissa, ‘History, Progress and Future Challenge of Islamic Insurance (Takaful) in Malaysia’ (Oxford Business & Economics Conference Program, St. Hugh’s College, Oxford University, UK, 2010) 6. Kazi Md. Mortuza Ali, *Introduction to Islamic Insurance* (Islamic Foundation Bangladesh, 2006) 38.

<sup>188</sup> Mohammed Obaidullah, *Islamic Financial Services*, (an e-book <<http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html>> 2005) 128; accessed 2 November 2011.

Figure 1



### 2.8.2 Mudaraba-based Takaful

Mudaraba is one of the major financial concepts of Islamic financial system. It is a contract whereby one party entrusts a sum of money to another party (Mudarib) to trade with for an agreed percentage of the profits. If there is any loss in the trade, the capital provider will bear it and the entrepreneur will have nothing for his efforts and time. The entrepreneur (Mudarib) is deemed to be the agent of the capital provider.<sup>189</sup> This financial concept is applied in this category of insurance policy in the following manner. An entrepreneur (insurer) creates a Takaful pool where he keeps the Takaful contributions (premiums) collected from the participants. The participants pay the premiums as ‘Musahama’<sup>190</sup> which is fixed considering the class of Takaful and on the basis of the sound principle of rate making. The insurer reserves a certain amount from Takaful pool to handle any unusual losses and invests the rest of the fund in accordance with the requirements of the Shairah principles.

<sup>189</sup>See, Aly Khorshid, *Islamic Insurance A Modern Approach to Islamic Banking* (Routledge 2004) 17. Professor R. Qaiser, ‘Takaful – the Islamic Insurance’ National Insurance Academy, page 4. <<http://www.niapune.com/pdfs/Research/TAKAFUL%20INSURANCE.pdf>> accessed 27 December 2012

<sup>190</sup> Ma’sum Billah used the term ‘Musahamah’ which means contribution instead of ‘tabarru’ which means donation. See, Dr. Mohd. Ma’sum Billah, *Islamic and Modern Insurance Principles and Practices* (Ilmiah Publishers, Malaysia, 2003) 262; Dr Renat I. Bekkin agreed with his view. See, Dr Renat I. Bekkin, ‘Islamic Insurance: National Features and Legal Regulation’ (2007) 21 Arab Law Quarterly 109, 114.



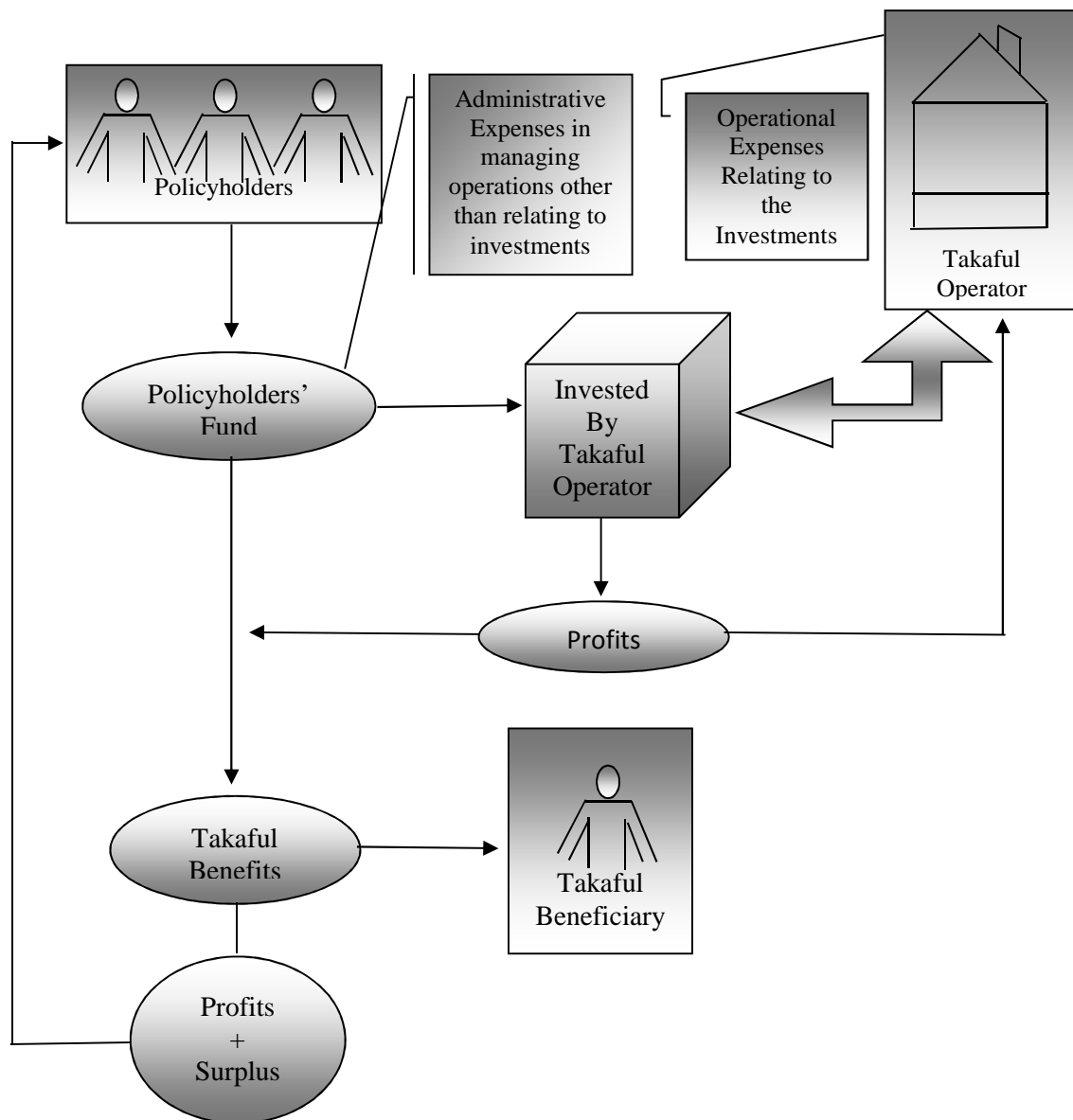
The administrative cost of operating the pool is paid from the pool. However, the administrative cost for investment is paid by the insurer. The profit from the business is shared between the insurer and the policyholders in the agreed ratio. The policyholders' profit is credited to the Takaful pool. The loss, if there is any, is covered from the fund in the Takaful pool, the insurer does not receive anything for his labour or time. The indemnity to the participant who suffered loss from the peril is paid from the Takaful pool. The surplus, 'that is the difference between premium received and claims paid',<sup>191</sup> and the share of the profit are paid back to the policyholders. However, the participant who has been indemnified for his losses does not receive the share of profit as he has been already compensated out of this fund. The participants may be asked, though in very rare cases, to contribute additional premiums to cover the deficit if any.<sup>192</sup> This model of Takaful is presented in Figure 2.

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<sup>191</sup> Mohammed Obaidullah, *Islamic Financial Services*, (an e-book <<http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html>> 2005) 130 accessed 2 November 2011. See also Zainal Abidin Mohd. Kasim, 'takaful: a question of surplus' in Sohail E. Jaffer (ed), *Regulatory approaches to takaful*, *Islamic Insurance: Trends, Opportunities and the Future of Takaful* (Euromoney Books 2007) 49.

<sup>192</sup> See, Kazi Md. Mortuza Ali, *Introduction to Islamic Insurance* (Islamic Foundation Bangladesh, 2006) 88-89; Professor R. Qaiser, 'Takaful – the Islamic Insurance' National Insurance Academy, page 5. <<http://www.niapune.com/pdfs/Research/TAKAFUL%20INSURANCE.pdf>> accessed 27 December 2012; Mohammed Obaidullah, *Islamic Financial Services*, (an e-book <<http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html>> 2005) 130 accessed 2 November 2011.

Figure 2



The major steps of this model are as follows:

- Policyholders pay premiums that are credited in the policyholders' fund.
- Takaful operator invests the policyholders' fund in Shariahh (Islamic law) complaint manner in its capacity as mudarib (Takaful operator).
- Operational expenses relating to the investments are charged to the Takaful operator. The expenses charged are the general and administrative expenses of the investment department only, as distinct from general and administrative expenses for the entire business.
- General and administrative expenses in managing the operations of the investment (other than relating to investments), are charged to the policyholders' fund.

- Profits generated from the investment are divided between the policyholders and the Takaful operator in an agreed ratio. Losses, if any, are charged to the policyholders' fund.
- Takaful benefits are paid to the Takaful beneficiary following a valid claim.
- The policyholders receive profits from the investment in the agreed ratio and the Takaful surplus. They are also required to make additional payment of deficit if any.

### **2.8.3 Wakala-based Takaful**

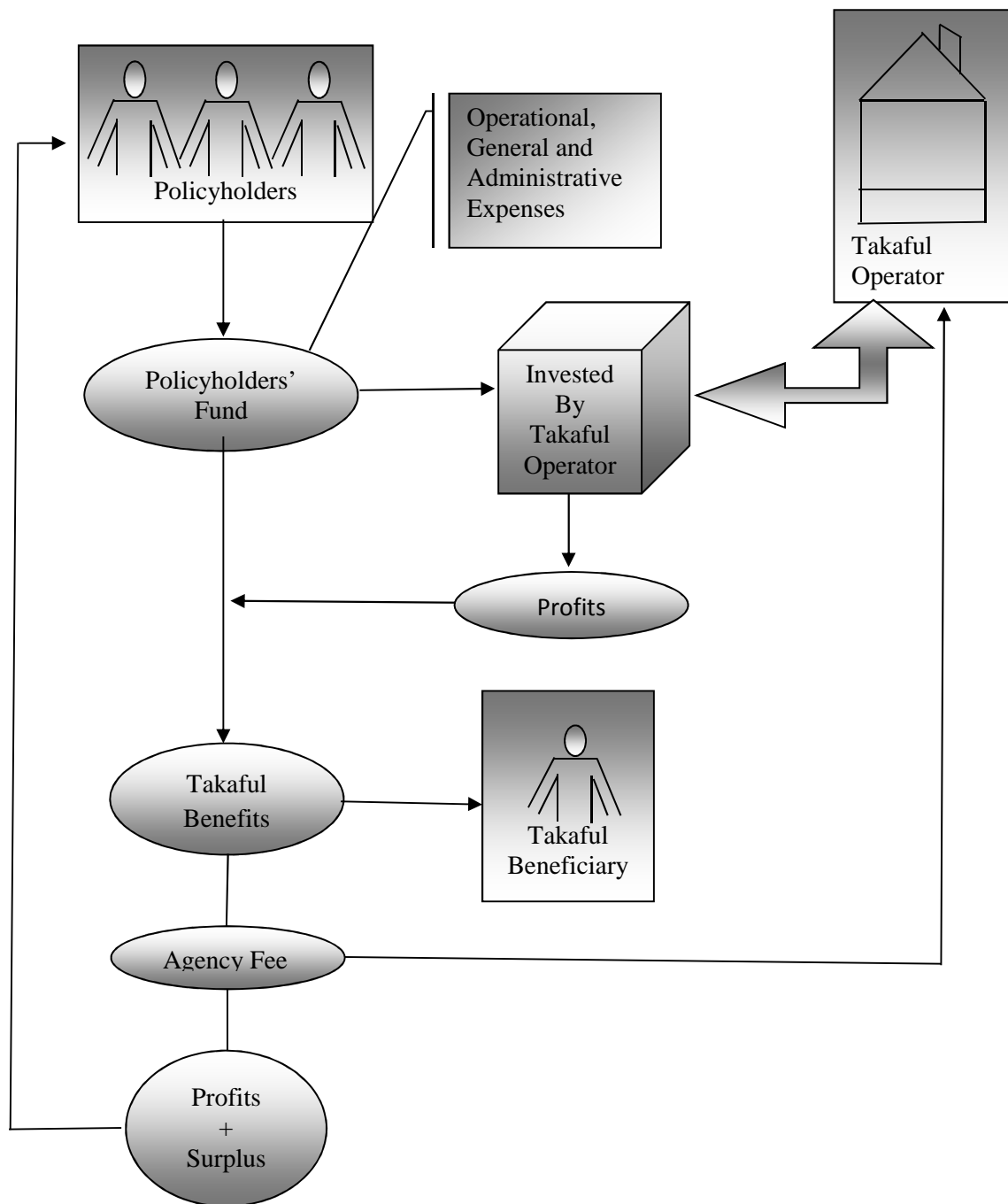
This model is generally used in the Middle East.<sup>193</sup> This is less complicated method of investment than the Mudaraba-based Takaful. In this method the insurer works as an agent (Wakil). His operation of the Takaful fund is similar to that of the Mudarib in the earlier method. However, the major difference in these two models is that the insurer of this model receives a fixed sum as remuneration for acting as an agent of the policyholders. In the Mudraba-based model, the insurer shares the profit (if any) and receives nothing if there is any loss. In the Wakala-based method the operational costs of maintaining the pool and investing the fund is paid from the pool. The full profit and surplus are paid back to the policyholders.<sup>194</sup> The model is presented in Figure 3.

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<sup>193</sup> Professor R. Qaiser, 'Takaful – the Islamic Insurance' National Insurance Academy, page 5. <<http://www.niapune.com/pdfs/Research/TAKAFUL%20INSURANCE.pdf>> accessed 27 December 2012.

<sup>194</sup> Mohammed Obaidullah, *Islamic Financial Services*, (an e-book <<http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html>> 2005) 130-132 accessed 2 November 2011.

Figure 3



The major scopes of this model are as follows:

- The policyholders pay premium that is credited to the policyholders' fund.
- The Takaful operator invests the fund in Shariahh complaint manner in its capacity as agent. As such all the expenses are charged to the policyholders' fund.
- The Takaful operator receives fixed remuneration or a percentage of the gross premium in returns of its work as agent.

- The Takaful benefit is paid to the beneficiaries following valid claims.
- The policyholders receive refund of Takaful surplus if any and the profits from the investment. If there is a deficit, they are also required to make additional payment.

#### **2.8.4 The Malaysian Model of Takaful**

In Malaysia, both conventional and Islamic insurance policies are practiced. The conventional policies are very competitive since the conventional insurers do not have to share the profit with the insureds nor the surplus. Consequently, conventional insurers can charge less premiums. Whereas the Mudarib or Mudaraba-based Takaful have to share the profits with the policyholders and pay back any surpluses.<sup>195</sup> Accordingly, a Takaful operation can either be a less profitable or a loss making project. In order to keep the Takaful product alive, policyholders are required to be charged by higher premiums than that of for conventional policies.<sup>196</sup> The higher premiums can make the system less popular and the system may collapse.<sup>197</sup> In such circumstances the Takaful operators modified the Mudaraba-based model by defining the surplus as profit and as such taking the share of it.<sup>198</sup> In this method the Takaful operator can charge premiums following the market rate and compete with the conventional policies.

However, there is a strong argument that the surplus belongs to the participants since it is the excess premiums paid by the participants and as such the insurer, as Mudarib, should not take share of it.<sup>199</sup> In considering this difficulty other models are invented using the Wakala-based Takaful. Since the insurer acts as an agent in this model he can fix the charge using different methods. For example, the agency fee would be 30% of Takaful fund and 50% of surplus or 50% of the Takaful fund and no share from surplus.<sup>200</sup>

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<sup>195</sup> In Malaysia Mudaraba-based Takaful has become popular.

<sup>196</sup> The author could not find any example how much the premium should be increased by.

<sup>197</sup> See, Zainal Abidin Mohd. Kasim, 'Takaful: a question of surplus' in Sohail E. Jaffer (ed), *Regulatory approaches to takaful*, *Islamic Insurance: Trends, Opportunities and the Future of Takaful* (Euromoney Books 2007) 48. The author could not find any example where the system has collapsed.

<sup>198</sup> Mohammed Obaidullah, *Islamic Financial Services*, (an e-book <<http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html>> 2005) 133 accessed 2 November 2011.

<sup>199</sup> See, Zainal Abidin Mohd. Kasim, 'takaful: a question of surplus' in Sohail E. Jaffer (ed), *Regulatory approaches to takaful*, *Islamic Insurance: Trends, Opportunities and the Future of Takaful* (Euromoney Books 2007) 50.

<sup>200</sup> *ibid* 48.

Another model invented and practiced in Malaysia is based on mixing both Mudaraba and Wakala based Takafuls. In this model, the Wakala method is used for underwriting activities, such as maintaining the Takaful fund and paying the claims. Since the insurer acts as an agent of the policyholders for conducting the underwriting activities, the insurer receives an agency fee which is 'normally a percentage of the contribution paid for the premium'. The insurer may also keep an incentive fee 'if there is a surplus in the policyholders fund as a result of managing the fund effectively'. The Mudarba method is used in the investment of the fund. Accordingly, the insurer receives an agreed percentage of the profits made from the business.

In conclusion, there is arguably no new method invented in Malaysia. The methods used are the combination of both Mudaraba and Wakala based methods.<sup>201</sup> The companies have freedom to choose any method as long as the model does not breach Shariah principles.<sup>202</sup> Their main goal of creating different methods of the application of Takaful is to make the Takaful business 'a profit-seeking commercial venture'.<sup>203</sup> It is evident from the record of the growth of the Takaful in recent years that they are successful in their approach.<sup>204</sup>

## **2.9 Shariah Principles that Shape the Contractual Part of Insurance Policy**

In addition to the specific prohibition of usury, gambling and uncertainty the Prophet (PBUH) provided many guidelines relating to business contracts. The underlying principle of these guidelines is to establish fairness and justice in business transactions.<sup>205</sup> The introduction of Shahih Muslim states that a 'careful study of "Kitab al-Buyu" (the book pertaining to business transactions) will reveal the fact that the Holy Prophet (PBUH) based business dealings strictly on truth and justice'.<sup>206</sup> In order to establish that truth and justice in the transaction, Prophet (PBUH) provided following guidelines, that should relate to insurance contract.

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<sup>201</sup> See, Razaleigh Muhamat, 'The Management of Takaful Business Models in Malaysia' (2012) 6(4) *Advances in Natural and Applied Sciences* 561, 562.

<sup>202</sup> See, *ibid* 562.

<sup>203</sup> See, <[www.takaful-malaysia.com](http://www.takaful-malaysia.com)> accessed 2<sup>nd</sup> November 2011.

<sup>204</sup> Yearly growth of the Takaful is 20% to 25% in the past five years. See, Iris Lai, 'Malaysia Seeks Takaful Growth with New Regulations' (November 2011) 1 *BestWeek* <[http://www.ambest.com/bestweek/marketreports/BWAP\\_Takaful.pdf](http://www.ambest.com/bestweek/marketreports/BWAP_Takaful.pdf)> accessed 5 July 2013.

<sup>205</sup> Dr. Mohd. Ma'sum Billah, *Islamic and Modern Insurance Principles and Practices* (Ilmiah Publishers, Malaysia, 2003) 195.

<sup>206</sup> There are six well accepted authentic books which encompass the Ahadith of Prophet (PBUH). They are prioritized on the ground of authenticity. Sahih Muslim is second in that category after Sahih Bukhari.

### ***Disclosure of information and acting with utmost good faith***

Hakim bin Hizam (RA) narrated that Prophet Muhammad (PBUH) stated that if both the seller and the buyer ‘spoke the truth and described the defects and qualities (of the goods), then they would be blessed in their transaction, and if they told lies or hid something, then the blessings of their transaction would be lost’.<sup>207</sup>

Allah (SWT) said in the Quran

إن الله يأمركم بالعدل والإحسان...

*Indeed, Allah orders justice and good conduct...*<sup>208</sup>

In another verse Allah (SWT) said

وتعاونوا على البر والتقوى...

*Help you one another in righteousness and piety...*<sup>209</sup>

Obaid bin Rafia from his father reported that the Prophet (PBUH) said that ‘the merchants will be gathered on the day of resurrection as transgressors except those who were fearful of Allah, pious and truthful’.<sup>210</sup>

Following these verses of the Quran and Ahadith it can be asserted that both the insured and insurer must be honest in their transaction, and must disclose every material fact that may affect the interest of the other, before taking policy and must act with utmost good faith considering the other’s interest in the contract.<sup>211</sup>

### ***Not to delay by a rich man in the payment of debt***

Abu Huraira (RA) reported that Allah’s Messenger (PBUH) said that ‘delay (in the payment of debt) on the part of a rich man is injustice’.<sup>212</sup> In an insurance contract an insured falls in a great danger when he faces the peril and he needs the money as soon as possible. The insurance company, in this case can be compared to the rich man who in the Hadith cannot

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<sup>207</sup> Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari* (Arabic reference) Hadith No. 2079, (USC Centre for Muslim-Jewish Engagement tr, <<http://www.usc.edu/org/cmje/religious-texts/hadith/bukhari/034-sbt.php>>) Vol. 3, Book 34, No. 293 accessed 5 July 2013.

<sup>208</sup> *The Holy Quran*, 16:90.

<sup>209</sup> *ibid* 5:2.

<sup>210</sup> Al-Haj Maulana Fazlul Karim (tr), *Mishkatul Masabih*, Book II. No. 6, p. 269.

<sup>211</sup> See, Dr. Mohd. Ma’sum Billah, *Islamic and Modern Insurance Principles and Practices* (Ilmiah Publishers, Malaysia, 2003) 195-207.

<sup>212</sup> Abu'l-Husain 'Asakir-ud-Din Muslim b. Hajjaj al-Qushayri al-Naisaburi, *Sahih Muslim*, (USC Centre for Muslim-Jewish Engagement tr, <<http://www.usc.edu/org/cmje/religious-texts/hadith/muslim/010-smt.php>>) Book 10, No. 3796 accessed 5 July 2013.

delay payment of a debt. Hence, there would be an injustice if the insurer delays in paying the claim.

### **2.10 English Insurance Law Governing the Contractual Part of a Policy**

English insurance law imposes the similar rules to that of the rules imposed by the Shariah principles. English insurance law requires both the insured and insurer to act with utmost good faith before and during the policy period under section 17 of Marine Insurance Act 1906. This section also requires the insured to act with utmost good faith in making a claim and the insurer in paying that claim. Section 18 of the Act requires the insurer to disclose every material fact before making the contract. The law also imposes the requirement of 'insurable interest' to prevent gambling in the guise of insurance. According to these similarities it becomes apparent that there is no contradiction between the Shariah principles and English insurance law in terms of contractual part of a policy. The difference, however, can be found in the application of these rules by English insurance law which is discussed below.

### **2.11 The Contradiction between Shariah Principles and English Insurance Law and the Method of Reconciliation**

It has been discussed in the First Chapter that both English insurance law and Shariah principles aim to achieve similar objectives. Both of them intend to establish fair balance between the parties in the contract, prevent gambling in the guise of insurance and moral hazard. In achieving these targets, English insurance law has imposed the requirements of insurable interest and utmost good faith. Shariah principles support both of these requirements. However, their method of application in English law makes these targets unachievable.

For example, English insurance law punishes the insured who fails to disclose a material fact due to an honest mistake in the same way as someone who conceals the fact with fraudulent intention. This is arguably highly unfair. The law imposes an unfair burden on the insured to judge the materiality of the fact considering the view of the insurer. The views of the insurer and the insured will naturally differ and it is impossible, particularly for the lay insured to decide what the particular insurer would want to know about. Unfairness can also be found in the law related to the claiming procedure. If the insured suffers losses for an unnecessary delay in payment of claim by the insurer, that insurer is not required to compensate the new



loss incurred by such delay.<sup>213</sup> Considering these and other factors, which are discussed in later chapters, academics, courts and the Law Commission all agree that sections of English insurance law cause injustice to the parties.<sup>214</sup>

However, establishing fairness is a complicated issue as the concept of fairness is a contested, subjective concept. One may consider a particular matter is fair and other may differ.<sup>215</sup> In such circumstances a question may arise that whether fairness from the viewpoint of the Law Commission, British Parliament or their courts should differ from that of the Islamic viewpoint. It is worthwhile re-quoting the following opinions of renowned Islamic scholars which can provide a perfect answer to this question. Imam Malik stated that,

Said ibn al-Musayyab said, "Umar ibn al-Khattab decided on a camel for each molar, and Muawiya ibn Abi Sufyan decided on five camels for each molar." Said ibn al-Musayyab said, "The blood-money is less in the judgement of Umar ibn al-Khattab and more in the judgement of Muawiya. Had it been me, I would have made it two camels for each molar. That is the fair blood-money, and everyone who strives with ijihad [research] is rewarded."<sup>216</sup>

These opinions confer three things, that every person has their own judgment in deciding the fairness, the Shariah does not specify what is 'fair',<sup>217</sup> and that every person researching to find the fairness will be rewarded. Shariah used different terms, such as justice, balance, to mean fairness. For example, Allah (SWT) said 'establish weight in justice and do not make deficient the balance'.<sup>218</sup> The literal meaning of the term 'free from bias, dishonesty and injustice', and can be understood as an act or decision that is made with honesty and sincerity concerning the parties and circumstances involved in it. The FSA, therefore, said that it 'is

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<sup>213</sup> See for instance, *Sprung v Royal Insurance (UK) Ltd* [1999] 1 Lloyd's Rep IR 111; [1997] CLC 70.

<sup>214</sup> See for instance, *Drake Insurance Plc v Provident Insurance Plc* [2003] EWCA Civ 1834; [2004] 1 Lloyd's Rep 268 [145] (Clarke L.J.); *Manifest Shipping Co Ltd v Uni-Polaris Shipping Co Ltd*; *The Star Sea* [2001] UKHL 1; [2001] 2 WLR 170, [57] (Lord Hobhouse); R.A. Hasson, 'The Doctrine of Uberrima Fides In Insurance Law- A Critical Evaluation' (1969) 32 MLR 615; Law Commission and The Scottish Law Commission, *Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured* (Consultation Paper No 182, Discussion Paper No. 134, 2007) para 1.57.

<sup>215</sup> See, *R v SSHD, ex p Doody* [1994] 1 AC 531, 560 (Lord Mustill).

<sup>216</sup> Imam Malik bin Anas, *Al-Muwatta*, (USC Centre for Muslim-Jewish Engagement tr, <<http://www.usc.edu/org/cmje/religious-texts/hadith/muwatta/043-mmt.php>>) Book 43, Number 43.12.7 accessed 5 July 2013.

<sup>217</sup> See for instance, Abu'l-Husain 'Asakir-ud-Din Muslim b. Hajjaj al-Qushayri al-Naisaburi, *Sahih Muslim*, (Arabic reference) Book 21, Hadith 3847, (USC Centre for Muslim-Jewish Engagement tr, <<http://www.usc.edu/org/cmje/religious-texts/hadith/muslim/009-smt.php>>) Book 9, No. 3582 accessed 5 July 2013; Ibn Majah, *Sunan Ibn Majah*, (Arabic reference) Book 12, Hadith 2308, (English reference) Vol. 3, Book 12, Hadith 2223.

<sup>218</sup> *The Holy Quran*, 55:7-9.

important to bear in mind that wording that is fair in one particular agreement is not necessarily fair in another'.<sup>219</sup>

Since the Shariah left the question of fairness to the subjective judgment the reconciliation between Shariah and English insurance law, in this regard, should be an easy job. The Law Commission have presented their view of fair law in different issues papers. They left the door open for the people to share their view regarding that proposed law and asked potential respondents to propose an alternative approach should they have one. This thesis is part of that approach, by analysing the current law, the law proposed by the Law Commission, the laws of other countries, the demands and circumstances of a party in the contract and recommends a fair approach for English insurance law. If English insurance law is so modified and the majority considers it fair and balanced the Shariah should accept it as suitable for Islamic policies, unless any of these rules breach other fundamental parts of Shariah which are discussed in the relevant chapters.

## **2.12 Conclusion**

It is clear that some significant research has already been conducted on the operational application of Islamic insurance policies. Moreover it is evident that Islamic insurance policies can be operated in the UK using the above-mentioned models. However, their application is hindered due to inconsistencies existing between the current English insurance law and Shariah principles. Whereas the ultimate targets of the English insurance law are consistent with Shariah principles as they both seek to establish a fair balance between the parties in the contract, preventing gambling in the guise of insurance and reducing the chance of moral hazard.

Hence, the author has discovered that modifying current English insurance law so as to achieve its targets would substantially reduce the current inconsistencies between the Shariah principles and English insurance law. The target of establishing fairness may cause uncertainty since this is a subjective concept. However, the Shariah does not specify what is fair. It leaves the matter to the subjective judgment warning that the balance has to be maintained. The balance of a particular thing depends on the surrounding circumstances.

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<sup>219</sup> FSA, 'Notice of Undertaking' (25 November 2011), <[http://www.fsa.gov.uk/pubs/other/rbs\\_insurance\\_undertaking.pdf](http://www.fsa.gov.uk/pubs/other/rbs_insurance_undertaking.pdf)> accessed 2<sup>nd</sup> February 2013. See also, *White v White* [2001]1 A.C. 596, 599 (Lord Nicholls of Birkenhead).

Consequently, if the English insurance law is modified and becomes a law that the majority considers fair, the Shariah should accept it suitable for Islamic policies unless it breaches other fundamental principle of Shariah.

## Chapter 3 – Insurable Interest in Life Insurance<sup>220</sup>

### 3.0 Introduction

The noble purpose of an insurance policy is to compensate the insured for when the unwanted peril occurs. The concept of unwanted peril is wide enough to attract gamblers to use an insurance policy as a gambling instrument. For example, if a gambler insures 3 of his friends' lives for £50,000 each, with premiums of £2,400 a year for each friend's life. If the policies are for three years and no one dies, the gambler would spend £21,600 in that period. If any one of the three friends dies, the gambler would receive £50,000, if two die he would receive £100,000 and if all three die he would receive £150,000. Such gains could serve as an incentive for the gambler to kill the lives insured. To stop such opportunity of gambling and moral hazard the lawmakers imposed the condition of 'insurable interest' to ensure that only real sufferers can obtain the money for their sufferings. This means that a person can insure the life of another only if he has pecuniary interest on the latter's life.

However, current English law allows the insured to recover the insured money even if that insurable interest is lost before the latter's death, opening the gate for gambling, in a different manner to that indicated above, potentially attracting criminal activity. The current method of application of 'insurable interest' also gives the insurer opportunity to do moral hazard.

Shariah principles do not specifically address the issue of insurable interest in a life insurance policy. However, Islamic academics argue, on the basis of Qiyas, that insurable interest should also be applied to Islamic life policies since Shariah principles do not allow gambling and moral hazard. The current method of application of insurable interest in English law leaves the door open for gambling and moral hazard means that Islamic policies cannot be applied under this law. However, the Law Commission has taken steps<sup>220</sup> to remove the opportunity for gambling and moral hazard. If their steps remove such opportunities for gambling and moral hazard then Islamic policies can be accommodated without finding any escape route. Consequently, the chapter will consider whether the recommended law can serve the purpose or not, if not the author will recommend a better solution.

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<sup>220</sup> The insurable interest is less important in indemnity policies and as such this chapter is only aimed to analyse the problems with the insurable interest in the life insurance policies.

### 3.1 Insurable Interest under English Insurance Law

In order to stop any possibility of gambling in the guise of insurance section 1 of the Life Assurance Act 1774 imposed the condition of insurable interest for a valid insurance policy.

The Section says:

... no insurance shall be made by any person or persons, bodies politick or corporate, on the life or lives of any person, or persons, or on any other event or events whatsoever, wherein the person or persons for whose use, benefit, or on whose account such policy or policies shall be made, shall have no interest, or by way of gaming or wagering; and every assurance made contrary to the true intent and meaning hereof shall be null and void to all intents and purposes whatsoever.

The section did not provide any guidelines as to how the ‘interest’ should be determined. In *Feasey v Sun Life Assurance Co of Canada*, Waller LJ acknowledged that ‘it is difficult to define insurable interest in words which will apply in all situations’.<sup>221</sup> He suggested that the ‘context and the terms of a policy with which the court is concerned will be all-important’ to determine the insurable interest.<sup>222</sup> The court in this case provided clear guidelines as to how to determine the existence of valid insurable interest. The court suggested asking four questions to find a valid insurable interest,<sup>223</sup>

- a) ‘[W]hat on the true construction of the policy is the subject matter of the insurance?’
- b) ‘Is there an insurable interest which is embraced within that subject matter?’
- c) ‘Is the insurable interest capable of valuation in money terms at the date of the contract?’
- d) Under s.3, ‘whether the sum payable under the policy is greater than the value of the pecuniary interest valued as of the date of the policy’.

The first question deals with the basic issue and as such does not require further analysis. The other three questions, and particularly the second question require further analysis as the Act does not define which categories of interest should be insurable. Waller LJ referred to different authorities that recognise a basic condition for a valid insurable interest, which is ‘the assured’s pecuniary interest in the subject-matter of the insurance arising from a relationship which is recognised in law’.<sup>224</sup> ‘A mere expectancy or hope of future pecuniary benefit from the prolongation of the life insured or of the fulfilment by him of moral

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<sup>221</sup> [2003] EWCA Civ 885 [71]

<sup>222</sup> *ibid* [71]

<sup>223</sup> *ibid* [98] (Waller LJ)

<sup>224</sup> Nicholas Legh-Jones QC, John Birds and David Owen (eds), *Macgillivray on Insurance Law* (11<sup>th</sup> edn, Sweet & Maxwell 2008) 9, para 1-13.

obligations owed to the assured, are insufficient to sustain insurable interest.<sup>225</sup> Consequently, in the absence of legal obligation on the assured to spend money for the life insured, no pecuniary interest was found between the relationship of parent and child in *Halford v Kymer*<sup>226</sup> and in *Harse v Pearl Life Assurance Co Ltd*.<sup>227</sup> In *Feasey v Sun Life Assurance Co of Canada*,<sup>228</sup> the Steamship Mutual Underwriting Association (“the club”) insured the liabilities of its members for personal injury or death sustained by crewmen and others on board their ships. The reinsurance was made in the form of personal accident cover under which fixed benefits became payable on the occurrence of relevant injuries and death. The defendants argued that the Club possessed no legal or equitable interest in the lives assured and had no legal relationship with them. The Court of Appeal held that the Club was not required to have such an interest or relationship. It was sufficient if the insured came under a liability to someone in the event of an injury to, or death of, the life assured. The defendants further argued that the Club incurred no liability towards a member upon the occurrence of death or injury, but only if and when a liability was established later, so that these contingencies gave rise only to an expectation of loss which was insufficient to support an insurable interest in the lives assured. This argument was supported by Ward LJ but the majority, Waller and Dyson LJJ, rejected it, holding that there was no reason why the legal obligation undertaken by the Club to its members at the start of the three year period should not give it a pecuniary interest in the lives and well-being of their employees. Waller LJ suggested that in a policy on life or lives the court should apply broad concept similar to property insurance where the insured is not required to have a ‘legal or equitable’ interest in the property. In his view, where the policy is on lives it will not be necessary to show a strict pecuniary loss recognised by law.<sup>229</sup>

The decision of the leading case *Dalby v India and London Life-Assurance Co*<sup>230</sup> should be sufficient for the analysis of the third point. In this case the court held that section 1 of Life Assurance Act 1774 only required the interest to be present at the day of taking policy<sup>231</sup> and established the concept that life insurance is an insurance of a set of money to be paid at the death of the life insured in consideration of the due payment of certain annual premiums paid

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<sup>225</sup> *ibid* 37, para 1-75.

<sup>226</sup> (1830) 10 B & C 724.

<sup>227</sup> [1903] 2 KB 92.

<sup>228</sup> [2003] EWCA Civ 885

<sup>229</sup> *ibid* [97]

<sup>230</sup> (1854) 15 CB 365.

<sup>231</sup> *ibid* 389 (Parke, B).

during the life even if the condition as to advantage, safety or other quality does not continue after creation of the policy or none of them exists at the time of his death.<sup>232</sup> The decision in *Hebdon v West*<sup>233</sup> explains the fourth point. In this case the assured took two policies with two insurance companies for the amounts of £5,000 and £2,500. Whereas, his interest at the day of taking policies was £3,000. He recovered £5,000 from the first insurance company and failed to recover any money from the second insurer since he had already recovered more than his interest.

However, the courts, and in one case the statute, have identified some exceptional cases where the parties have a deemed insurable interest and the section 3 is regarded as inapplicable. The reason being is that these relationships are based on love and affection and as such they are outside the mischief of wagering that the 1774 Act was passed to prevent. These are, firstly the insurance on the insured's own life. Farwell LJ said in *Griffiths v Fleming and Others* that 'A man does not gamble on his own life to gain a Pyrrhic victory by his own death'.<sup>234</sup> Another such relation is insurance on spouse's life. Lord Kenyon said in *Reed v Royal Exchange Assurance Co* that 'it must be presumed that every wife had an interest in the life of her husband'.<sup>235</sup> Farwell LJ said in *Griffiths v Fleming and Others* that 'a husband is no more likely to indulge in "mischievous gaming" on his wife's life than a wife on her husband's'.<sup>236</sup> It is not a question of property at all; it is that for this purpose husband and wife stand on the same footing'. Finally, Section 253 of the Civil Partnership Act 2004 specifically stated that a civil partner shall have unlimited insurable interest on the other, placing them in the same position as a marriage couple.

Since there is a deemed insurable interest in the above exceptional relationships and there is no chance of gambling, the parties are allowed to insure their life for any amount they want. Pollock B, said that there is 'nothing to prevent any person insuring his own life a hundred times...provided its bona fide insurance on his life'.<sup>237</sup> Farwell LJ said,

But this must be on the ground that an insurance by a man on his own life is not within the mischief of the Act... I cannot persuade myself that such an insurance is of

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<sup>232</sup> See *Hebdon v West* (1863) 3 B & S 579.

<sup>233</sup> *ibid.*

<sup>234</sup> [1909] 1 KB 805, 808; See, *Wainwright v Bland* 1 Moo. & R. 481.

<sup>235</sup> Peake, Add. Cas. 70.

<sup>236</sup> [1909] 1 KB 805. 821.

<sup>237</sup> *M'Farlane v Royal London Friendly Sy* (1886) 2 TLR 755, 756.

a pecuniary interest or ... that if the man dies he will gain an advantage, if he lives he will suffer a loss. The loss is in both cases his own, being either of his own life or of his premiums... It is not a question of property at all.<sup>238</sup>

The relationship between husband and wife has been considered in the same way and so they can insure for any amount they like.<sup>239</sup> The same ruling has been applied by the Insurance Ombudsman for the relationship between fiancés on the same grounds.<sup>240</sup>

### 3.2 Critical Analysis of the Current Law

It is evident that the courts in several cases have endeavoured to correct the loopholes of the requirement 'insurable interest'. Yet, there is still scope in the following issues for critical analysis. Firstly, when should the insurable interest exist? And, should the value of the insurable interest be calculated after the death of the insured or on the day the policy is issued?

The court in *Dalby v India and London Life-Assurance Co*<sup>241</sup> established, interpreting section 3 of Life Assurance Act 1774, that a life policy is a contingency policy under which a person can recover the whole insured amount after the death of the insured person. The insured amount is to be decided on the day of taking the policy. The insured is only allowed to insure the amount equivalent to the value of his interest on the life insured. Considering section 1, which imposes the requirement of insurable interest for a valid policy, and section 3, Parke B held that the insurable interest has to exist only on the day of taking the policy. Consequently, the insured can recover the insured amount even if the interest is lost after the day of taking policy. He said that it is a contract for a set amount of money against which an 'unvarying and uniform premium' to be paid by the insured for a certain period in return of which the insured shall obtain that set amount if the insured person dies within that period. In consequence, an insured such as a creditor who received the debt amount soon after taking the policy on that amount would also get the insured amount if the debtor, on whose life the policy was taken, died before the policy expired. Needless to say that the purpose of taking a policy in this case was to be compensated at the event of loss.<sup>242</sup> Whereas, the insured did not

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<sup>238</sup> *Griffiths v Fleming and Others* [1909] 1 KB 805, 821.

<sup>239</sup> *ibid* 821 (Farwell LJ).

<sup>240</sup> Insurance Ombudsman Bureau, *Annual Report* (1989), paras 2.31-2.35.

<sup>241</sup> (1854) 15 CB 365, 139 ER 465.

<sup>242</sup> See the definition of insurance contract given by the court in *Prudential Insurance v Inland Revenue Commissioners* [1904] 2 KB 658 and by the Scottish court in *Scottish Amicable Heritable Securities Association Ltd v Northern Assurance Co* (1883) 11 R 287.



suffer any loss after the death of the debtor. Accordingly, the purpose of taking the policy went over by the payment of the debt amount. Where the principal purpose of a contract is lost the party for whose benefit the contract has been made loses his interest in that contract. The best example of this type can be found in general Contract law. In *Krell v Henry*<sup>243</sup> the defendant agreed in writing to hire rooms in the plaintiff's flat in order to see the Coronation processions. The written contract made no express reference to the processions, but it was clear from the circumstances that both parties regarded the viewing of the processions as the sole purpose of the hiring. When the processions were postponed, the defendant declined to pay the balance of the agreed rent, and the Court of Appeal upheld his refusal, on the ground that 'the Coronation procession was the foundation of this contract and that the non-happening of it prevented the performance of the contract'.<sup>244</sup> Similarly in an insurance contract, the insured loses his interest in the contract once the principal purpose is lost. In such case an insured, it is assumed that, can continue the contract by paying premiums only if he has the intention to kill the life insured or gamble on that life. Consequently, the current approach, that is established by the court in *Dalby v India and London Life-Assurance Co*<sup>245</sup> goes against the basic principle of the Life Assurance Act which established the rule of insurable interest to prevent both the moral hazard, i.e. killing the insured life, and gambling.<sup>246</sup>

### 3.3 Approach of the Law Commission

The Law Commission has identified several problems with the current law requiring insurable interest. It is difficult to identify the insurable interest,<sup>247</sup> the dependents can find it difficult to obtain a policy on their supporters' life in the absence of legal relationship,<sup>248</sup> and in the absence of the requirement of insurable interest at the time of claim the problems of moral hazard and wagering continue to exist.<sup>249</sup> By finding these problems with the existing approach of requiring an insurable interest, the Law Commission, following the Australian example, considered its abolishment. They justified this approach on three grounds:

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<sup>243</sup> [1903] 2 K.B. 740. See *Taylor v Caldwell* (1863) 3 B. & S. 826.

<sup>244</sup> *ibid.*, 751 (Vaughan Williams LJ).

<sup>245</sup> (1854) 15 CB 365.

<sup>246</sup> The Law Commission and the Scottish Law Commission, *Insurance Contract Law: Issues Paper 4 Insurable Interest* (14 January 2008) paras 2.3, 2.4.

<sup>247</sup> *ibid.* para 4.2.

<sup>248</sup> *ibid.* paras 4.7- 4.8.

<sup>249</sup> *ibid.* para 4.15.

*(1) Defining insurance*

They considered whether it is possible to identify the contract of insurance without insurable interest distinguishing it from wagers and other financial contracts. The FSA opined in affirmative. In the view of FSA the insurable interest is ‘not itself a defining feature’ of the contract of insurance.<sup>250</sup> Their guidance in PERG 6 of the FSA’s Handbook of Rules and Guidance makes it clear that the purpose for which a policyholder buys a contract of insurance is not relevant to the identification of a contract of insurance. The guidance states that ‘the “assumption of risk” by the provider is an important descriptive feature of all contracts of insurance’.<sup>251</sup> They did not use insurable interest in order to distinguish insurance contract from other contracts, and neither was it used to identify the contract of insurance. In addition to the view of the FSA, the Law Commission have considered the definition of insurance under common law and concluded that the existence of insurable interest is not specifically required to define it under common law.<sup>252</sup> It is also found that insurance is possible to be defined without insurable interest for the purposes of the Financial Services and Markets Act 2000, accounting and tax.<sup>253</sup> The Law Commission considered the current practical example of Australian law<sup>254</sup> which abolished the requirement of insurable interest in 1995 and have seemingly faced no difficulty in distinguishing insurance from other contracts.<sup>255</sup> Considering these factors the Law Commission concluded that ‘it is possible to define insurance without using the statutory insurable interest’.<sup>256</sup>

*(2) Whether insurable interest is required to prevent gambling*

The concept regarding gambling has been significantly changed in recent years. The Gambling Act 2005 has repealed the Gaming Act 1845 allowing gambling contracts to be enforced through the courts. However, ‘the original ‘mischief’ that insurable interest was intended to prevent was not gambling itself but gambling in the guise of insurance’.<sup>257</sup> Both the Gambling Commission, set up by the Gambling Act 2005, and the FSA have the power to govern and distinguish wagers and insurance making it possible to prevent gambling in the

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<sup>250</sup> FSA, *Policy Statement* (04/19, July 2004) para 2.10.

<sup>251</sup> FSA, ‘Guidance on the Identification of Contracts of Insurance’, PERG 6 Release 139, July 2013, para 6.6.2

<sup>252</sup> The Law Commission and the Scottish Law Commission, *Insurance Contract Law: Issues Paper 4 Insurable Interest* (14 January 2008) paras 7.18 – 7.23.

<sup>253</sup> *ibid* paras 7.6, 7.26, 7.28, 7.30.

<sup>254</sup> See, sections 16(1) and 18(1) of Insurance Contracts Act 1984.

<sup>255</sup> The Law Commission and the Scottish Law Commission, *Insurance Contract Law: Issues Paper 4 Insurable Interest* (14 January 2008) para 7.33.

<sup>256</sup> *ibid* para 7.32.

<sup>257</sup> *ibid* para 7.35.

guise of insurance without using insurable interest. However, underwriters fear that without the insurable interest the industry could slip to the lowest common denominator and offer policies that look more like wagers than insurance. The Law Commission stated that people are still gambling on the death of celebrities as they did in the eighteenth century when the Life Assurance Act 1774 was passed.<sup>258</sup> Therefore, ‘this may be a precautionary argument for retaining a requirement of statutory insurable interest to distinguish gambling from insurance’.<sup>259</sup>

*(3) Whether the insurable interest is required to prevent moral hazard*

The Law Commission stated that the insurable interest is imposed in life policy ‘to prevent contracts of insurance creating incentives to murder’.<sup>260</sup> They identified several factors such as the assignment of life policies to strangers,<sup>261</sup> and unlimited deemed insurable interest on spouse’s life undermine the effectiveness of the rule of insurable interest. Moreover, the ‘existence of the police, criminal penalties and the Proceeds of Crime Act 2002 (which prevents anyone benefiting financially from wrongdoing) do a more effective job at preventing insurance becoming an incentive to murder than the concept of insurable interest’.<sup>262</sup>

However, all of the aforementioned factors are overpowered by the fact that individuals ‘are uncomfortable at the thought that people who do not wish them well can take out policies on their lives’.<sup>263</sup> Consequently, ‘taking out an insurance policy on someone’s life could be used as a threat’.<sup>264</sup> The Law Commission, therefore, opined in favour of retaining the statutory requirement of insurable interest but with some amendments.<sup>265</sup> They recommended two-fold amendments, firstly, relaxing the restrictions imposed by the existing rules of insurable interest by extending the class of natural affection and amending the test of legal and pecuniary interest to a reasonable expectation of pecuniary loss. Also, by allowing a policyholder to insure anyone’s life with his/her consent as an alternative if he fails to

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<sup>258</sup> *ibid* para 7.36

<sup>259</sup> *ibid* para 7.36.

<sup>260</sup> *ibid* para 7.38.

<sup>261</sup> See, *Patel v Windsor Life Assurance Co Ltd* [2008] EWHC 76 (Comm).

<sup>262</sup> The Law Commission and the Scottish Law Commission, *Insurance Contract Law: Issues Paper 4 Insurable Interest* (14 January 2008) para 7.38.

<sup>263</sup> *ibid* para 7.40.

<sup>264</sup> *ibid* para 7.40.

<sup>265</sup> *ibid* para 7.40.

establish pecuniary interest on that life. These proposed amendments shall be analysed in the later part of this Chapter.

### 3.4 Approach in Australia

Whilst academics and the Law Commission doubt the necessity of the statutory requirement of insurable interest, this requirement has already been withdrawn in Australia. Section 18 (2) of Insurance Contracts Act 1984 (ICA) states that a contract ‘is not void by reason only that the insured did not have, at the time when the contract was entered into, an interest in the subject-matter of the contract’. It is interesting to note that only one member of the Law Reform Commission argued to withdraw the requirement. He said that the general law of gaming and wagering is sufficient to ensure that the policyholder has an interest of some kind in the life insured. Further, the criminal law, the law of negligence and other laws provide ‘adequate protection against the possibility of disposal of the life insured’.<sup>266</sup> Moreover, the payment of premiums ‘provides a substantial inhibition against purely hypothetical or speculative insurance in another’s life’.<sup>267</sup> He argued that the requirement of insurable interest ‘will only affect those cases in which the policyholder has some interest, so that the contract is not caught by gaming and wagering legislation, but does not fall within one of the recognised categories of insurable interest’.<sup>268</sup> Furthermore, the penalty of avoidance for lack of insurable interest operates against the insured whereas the insurer is the person who issues the policy with no insurable interest and as such he should be punished. He further argued that ‘the retention of the requirement of insurable interest would simply introduce an unnecessary distinction between life and general insurance’.<sup>269</sup>

Whereas the majority of the Law Reform Commission recommended retaining the requirement of the interest. They considered that the main argument against the requirement of insurable interest was that ‘an assignee of a policy need not possess an insurable interest in the life insured’.<sup>270</sup> However, they believed that the anomaly related to assignment of the policy was not a sufficient reason for abandoning the requirement of interest.<sup>271</sup>

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<sup>266</sup> The Law Reform Commission, *Insurance Contracts, Report No 20*, (1982) para, 146. See, Kenneth Sutton, *Insurance Law in Australia* (3<sup>rd</sup> ed, LBC Information Services, 1999) para 6.33.

<sup>267</sup> *ibid* para, 146.

<sup>268</sup> *ibid* para, 146.

<sup>269</sup> *ibid* para, 146. See, The Hon Michael Kirby AC CMG, ‘Australian Insurance Contract Law: Out of the Chaos – a Modern, Just and Proportionate Reforming Statute’, (2011)22 ILJ 1, 16.

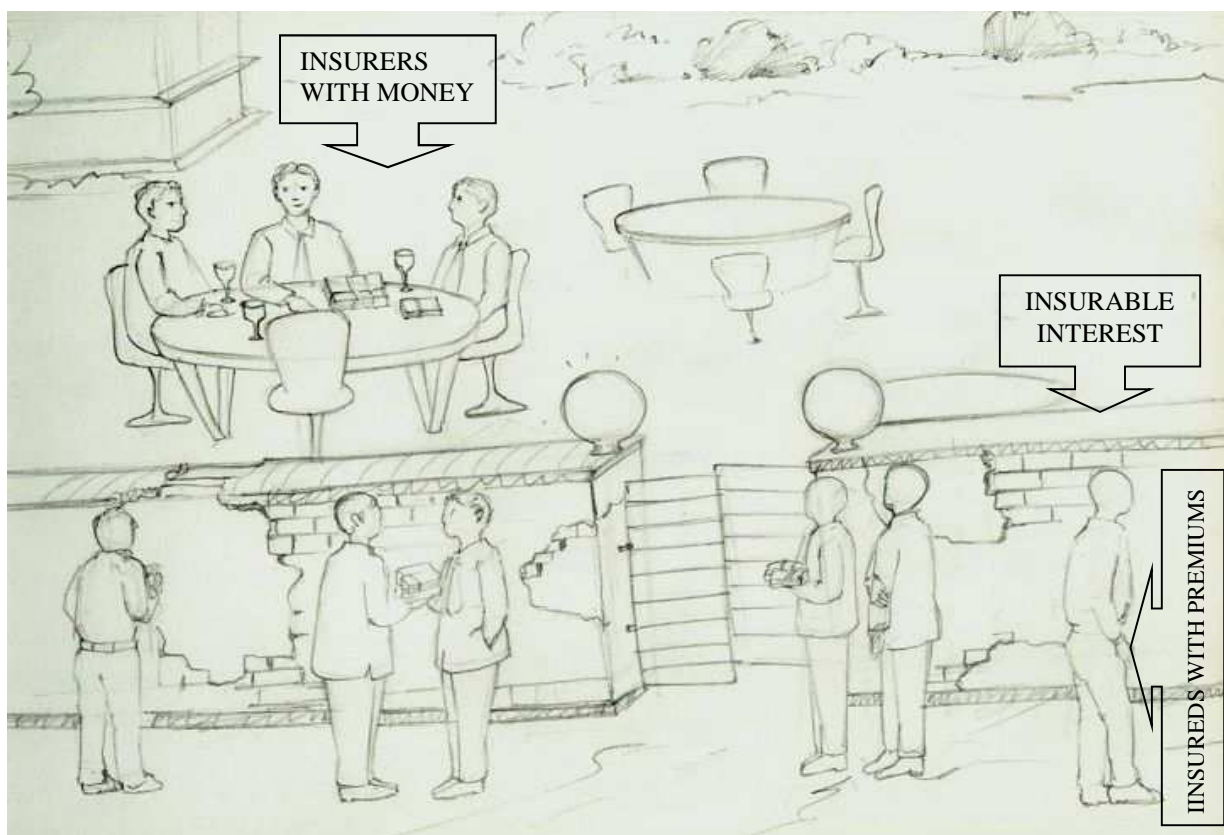
<sup>270</sup> *ibid* para, 145. See for instance, *Patel v Windsor Life Assurance Co Ltd* [2008]EWHC 76 (Comm).

<sup>271</sup> *ibid* para, 145.

However, following this Act, a person can insure anyone's life on the street, no matter if he knows him or not. He will receive the insured money once the person dies since there is no requirement of interest at the time of death either.<sup>272</sup> Accordingly, 'the legislature [is] apparently being prepared to accept the risk that this situation will encourage wagering or gaming on the lives of others'.<sup>273</sup>

### 3.5 Critical Analysis and Recommendation

The following picture will clarify the actual position of an insurance contract, insurable interest and two parties i.e. insureds and insurers.



In this picture the insurers are inside the premises and the policyholders are outsiders. The policyholders will come to the insurers to insure a life in return of premiums and the insurers will pay the insured money if the life insured dies. There are possibilities that some ill-minded people may come in and misapply the system such as for the purpose of gambling on other's life or with the intention of moral hazard. Therefore the law imposed a barrier in the

<sup>272</sup> Kenneth Sutton, *Insurance Law in Australia* (3<sup>rd</sup> edn, LBC Information Services, 1999) para 6.34.

<sup>273</sup> *ibid* para 6.34.

form of a gate named insurable interest. The law expected that only the people who are in need of the benefit from the system would be able to enter through the gate. If anyone does not enter through the gate, their entrance will not be legal and they will not get the benefit of the system i.e. the contract will be illegal. However, the gate, prevents some people, such as parents, who are in need of the benefit of the system to enter. The real boundary of the gate is not clear and as such the outsiders i.e. the insureds are in many cases confused whether they are really entering through the proper gate or not, and when the question of the valid entry is raised, if it is found that they did not enter through the gate, they are subsequently kicked out of the premises. On the other hand, the insurers, do not bother who is entering through the gate and who is not, since they have the option to kick the insured out of the premises any time after making the contract claiming that he did not enter through the proper gate. Usually the insurers take advantage of this process by raising the issue of valid entry once the person insured dies. If the person insured does not die, the insurers do not raise this issue since they are having the benefit of the contract. Hence, the US academic Jacob Loshin argued that the doctrine has perverse consequences in three dimensions.<sup>274</sup> Firstly, when an insurance contract is invalidated for lack of insurable interest, the insurer gets relief from paying the insured amount. This ‘encourages insurers to issue more such policies’ which they predict would be invalidated for lack of insurable interest. Further, in many cases it is unclear whether the insurable interest exists or not, and if exists, how much.<sup>275</sup> This ‘doctrinal uncertainty permits insurers to maintain the appearance of good faith for policies that are not clearly invalid when issued. Taken together, these dynamics create perverse incentives that work to subsidize moral hazard rather than to discourage it’.<sup>276</sup> For example, in *Patel v Windsor Life Assurance Co Ltd*<sup>277</sup> the insurer Virgin Direct issued a policy on Mr Barot’s life even after they found some anomaly in the statements made in the application form. They raised these issues once the insured amount was claimed. The second issue is that ‘uncertainty about the doctrine’s application creates an opportunity for insurers to exploit policyholders’.<sup>278</sup> The doctrine allows insurers to take two-steps, sell a contract ‘with as much willful indifference to the insurable interest requirements as doctrinal ambiguity will

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<sup>274</sup> In the U.S.A the insurable interest is also required at the time of taking policy.

<sup>275</sup> Jacob Loshin ‘Insurance Laws’ Hapless Busybody: A Case Against the Insurable Interest Requirement’ (2007) *The Yale Law Journal* 474, 485, 487-488; See, the Law Commission and the Scottish Law Commission, *Insurance Contract Law: Issues Paper 4 Insurable Interest* (14 January 2008) para 4.3, 4.12.

<sup>276</sup> *ibid* 477, 490-493.

<sup>277</sup> [2008] EWHC 76 (Comm).

<sup>278</sup> Jacob Loshin ‘Insurance Laws’ Hapless Busybody: A Case Against the Insurable Interest Requirement’ (2007) *The Yale Law Journal* 474, 478.

allow’,<sup>279</sup> and then, when the peril occurs ‘claim that the contract had no insurable interest after all and escape obligation for payment’.<sup>280</sup> Thus the doctrine is ‘impeding the goal of fairness in the insurance market’.<sup>281</sup> Finally, he argued that,

‘[T]he link between insurable interest and moral hazard remains inexact. Even if we could be sure that an insurance contract has an insurable interest, the presence of such an interest does not necessarily reduce the contract’s level of moral hazard...In many situations, other factors limit the amount of moral hazard caused by a supposed lack of insurable interest. For example, a large company that insures a nonessential employee may still have plenty of reasons not to murder the employee.’<sup>282</sup>

Consequently, ‘the imperfect relationship between the legal standard of “insurable interest” and the actual presence of moral hazard suggests that the doctrine may end up invalidating unobjectionable and mutually beneficial insurance contracts, thus impeding the goal of economic efficiency in the insurance market’.<sup>283</sup> He further argued that the doctrine is causing unfair consequences such as, a husband has an insurable interest on his wife’s life even if he is an ‘abusive tyrant’, whereas there is no insurable interest on ‘beloved grandmother, aunt, or son-in-law’.<sup>284</sup> He claimed that there is no possibility of gambling in the guise of insurance since it is a business where consumers ‘trade risk for certainty – predictable premiums and compensation instead of worry about whether future loss might occur’. This trade may initially look like gambling, but it is not. He said

If consumers simply lent their money to a gambler, they would receive no certainty that the gambler would have enough money to pay in the event of a loss. Unlike a gambler, an insurance company profits by acquiring the risk of its consumer, converting this raw risk into certainty, and then selling the certainty back to the consumer in the form of premiums that equal the expected cost of payouts. The insurer acquires the consumer’s risk, not simply as a gamble, but because the insurer is better than the consumer at reducing it.<sup>285</sup>

Whilst the gate i.e. the doctrine of insurable interest can cause perverse results in terms of moral hazard, causing unfairness and it has no scope to stop gambling, and since insurance is a business of certainty. Loshin argued that the gate should be removed. He claimed that the

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<sup>279</sup> *ibid* 495.

<sup>280</sup> *ibid* 495.

<sup>281</sup> *ibid* 478.

<sup>282</sup> *ibid* 488-489.

<sup>283</sup> *ibid* 478.

<sup>284</sup> *ibid* 484.

<sup>285</sup> *ibid* 504-505.

insurers will do better in reducing the moral hazard than the judges who only rely on insurable interest.<sup>286</sup> Wickens argued that,

The removal of the requirement of insurable interest would place on life offices the onus of ensuring that justification existed for the individual assurances accepted by them...they would obtain greater flexibility in deciding what types of interest warrant protection by life assurance. The policy owner also would stand to gain from the change, as this would result in the office being bound as soon as the policy was issued and would thus remove the possibility of the policy being declared void at some future date on the grounds that no insurable interest existed when it was effected.<sup>287</sup>

Loshin argued that insurers will introduce different methods such as ‘deductible, coinsurance, coverage limits, and coverage exclusions’ to stop or reduce moral hazard in the interest of their businesses.<sup>288</sup> If there is no gate, they will know that there is a possibility of ill-minded people to enter into the premises and as such they will be very cautious in choosing whom they enter into a contract with, leading to a reduced amount of moral hazard. If they choose to enter into a contract with a person who may cause moral hazard, they will increase the premiums treating it as a high-risk policy so as to recover their costs which they are not currently doing. With the high rate of premiums, the insured will lose his interest to enter into the contract. Consequently, the purpose will be served better than that of the gate and the third parties, on whose life the policy is taken, will also be in safer position.<sup>289</sup>

The effect of his argument can be found in Australia where the gate has already been removed and the insurers in practice assess the proposals and determine the risks using the test of insurable interest before entering into a contract.<sup>290</sup> Michael O’Brien therefore argued ‘that insurable interest is alive and well and practiced in Australia, even though many seem to be reluctant to admit it’.<sup>291</sup> It is evident from the attitude of the insurers in Australia that insurable interest should exist even if the law does not recognise it. Hence, the removal of the requirement cannot solve the problem. The removal will increase the risk of gambling and

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<sup>286</sup> *ibid* 508.

<sup>287</sup> Wickens, ‘Policy Provisions of the Life Insurance Act’, (1969) *Transactions of the Institute of Actuaries of Aust. And N.Z.* 189, 201.

<sup>288</sup> Jacob Loshin ‘Insurance Laws’ Hapless Busybody: A Case Against the Insurable Interest Requirement’ (2007) *The Yale Law Journal* 474, 477, 506. See, Kenneth S. Abraham, *Insurance Law and Regulation* (4<sup>th</sup> edn, The Foundation Press 2005) 7; Robert B. Cooter and Tomas Ulen, *Law and Economics* (5<sup>th</sup> edn, Prentice Hall 2008) 53; George L. Priest, ‘Insurability and Punitive Damages’ (1989) 40 *ALA. L. Rev.* 1009, 1025.

<sup>289</sup> *ibid* 507-508.

<sup>290</sup> See, Law Commission and Scottish Law Commission, *Insurance Contract Law: Issues Paper 4 Insurable Interest* (14 January 2008) foot note 26 of Part 7.

<sup>291</sup> Michael O’Brien, ‘Insurable interest — Social welfare & semantics’ (2006) 17 *ILJ* 105, 117.



moral hazard instead, as Kenneth Sutton stated ‘the legislature [is] apparently being prepared to accept the risk that this situation will encourage wagering or gaming on the lives of others’.<sup>292</sup> Furthermore, ‘insurers cannot always be relied upon to make decisions which are consistent with the public interest’.<sup>293</sup> In the US case, *Liberty National Life Insurance Company v Weldon*<sup>294</sup> a woman took out three insurance policies with different insurers on the life of a child of her deceased husband’s sister. She subsequently murdered the child. The child’s father successfully sued the companies in question for damages for the wrongful death of the child since they knew or ought to have known that the woman lacked insurable interest in the child’s life.

However, the Law Commission argued that the ‘existence of the police, criminal penalties and the Proceeds of Crime Act 2002 (which prevents anyone benefiting financially from wrongdoing) do a more effective job at preventing insurance becoming an incentive to murder than the concept of insurable interest’.<sup>295</sup> It is submitted that relying on police and the Acts leaving the door open is not a wise approach.<sup>296</sup> The law itself asks people to take their necessary protection by imposing barriers like the gate in the house rather than keeping the door open and expecting that police will chase the criminals. Similarly in the case of an insurance contract the gate i.e. insurable interest should not be withdrawn to let the ill-minded people come in and subsequently expect that the police will chase them.

It is further argued that the argument of selling certainty, made by Loshin, in the case of insurance can be seen in different angle. In an insurance policy an insured, for example A, intends to insure B’s life (who he does not know) for the amount of £50,000. If the insurer takes the policy it will be nothing but a gamble on the life of B since A has nothing to lose should B die. Here, B is like a casino machine. The game is decided on his death within the period of the play. If he dies within that period, A will win £50,000 in return of payments i.e. premiums, made for using the machine. If he does not die within that period the insurer will obtain those amounts i.e. premiums from A. There is no question of selling certainty in this case since A has no risk of losing anything due to B’s death. Consequently, the possibility of

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<sup>292</sup> Kenneth Sutton, *Insurance Law in Australia*, (3<sup>rd</sup> edn, LBC Information Services, 1999) 6.34.

<sup>293</sup> The Law Reform Commission, *Report No 20 - Insurance Contracts*, (1982) para 143.

<sup>294</sup> 100 So 2d 696 (1957)

<sup>295</sup> Law Commission and Scottish Law Commission, *Insurance Contract Law: Issues Paper 4 Insurable Interest* (14 January 2008) para 7.38. See also the argument of dissenting member of The Law Reform Commission, *Insurance Contracts, Report No 20*, (1982) para, 146

<sup>296</sup> See, The Law Reform Commission, *Insurance Contracts, Report No 20* (1982) para 145.

gambling exists where there is no risk of loss on the death of the life insured. The risk of killing B is also high since it is just a game for A on the life of B. Loshin argued that the insurer would increase the premiums where there is a risk of moral hazard and as such the insured would lose interest in taking policy. Such argument should fail in the case of insurance where the insured had sufficient interest at the time of taking policy but lost few months after. For example, when a husband takes a policy on his wife's life the insurer should not increase premiums considering the possibility of moral hazard. If they get divorced a couple of months after taking the policy, the insurer shall have no option to increase premiums. Consequently, the argument of Loshin would also not work in this example.

Furthermore, the chance of gambling and possibility of moral hazard in the absence of insurable interest will create further risk of threat for the life insured. The Law Commission identified that individuals are 'uncomfortable at the thought that people who do not wish them well can take out policies on their lives' and taking out policy on another's life could be a threat for him.<sup>297</sup> They, therefore, provisionally proposed to keep the gate. The author also argues that the gate, the doctrine of insurable interest, should continue to exist but that this hundreds-year-old gate should be reformed.

### **3.5.1 Extension of the Gate**

The Law Commission are of the opinion that 'the category of insurable interest supported by the natural affection should be increased, giving a larger class unlimited rights to insure others' lives'.<sup>298</sup> They proposed to include the interest on the life of guardian, parent, children and cohabitant in that category.<sup>299</sup>

For the category of insurable interest that depends on legal pecuniary loss, the Law Commissions proposed to relax the test for establishing an insurable interest. They proposed that 'the requirement should be that the policyholder has a reasonable expectation of pecuniary or economic loss on the death of the life insured, rather than a pecuniary interest

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<sup>297</sup> The Law Commission and the Scottish Law Commission, *Insurance Contract Law: Issues Paper 4 Insurable Interest* (14 January 2008) para 7.40.

<sup>298</sup> *ibid* para 7.61.

<sup>299</sup> *ibid* para 7.62.

recognized by law'.<sup>300</sup> The policyholder in such case 'should be able to insure the life for the value that is equivalent to the reasonable expectation of the loss'.<sup>301</sup>

In New York and Germany the law requires policyholders to obtain consent from the life insured before taking the policy. The Law Commissions argued that such requirement would create problems where insurable interest exists but consent is refused. This will also 'be impractical in commercial situations' and in 'domestic situations it may in practice be difficult for a vulnerable life insured to refuse consent'.<sup>302</sup> The Law Commission, therefore, refused to make the consent as the sole requirement or an additional requirement for insurable interest.<sup>303</sup> They, however, proposed to use consent 'as an alternative way of establishing insurable interest when a pecuniary interest or an interest arising out of natural affection cannot be found'.<sup>304</sup> Needless to say that the proposed way of widening the gate, i.e. using the consent as an alternative option, shall not be able to reduce the moral hazard from the part of the insurer.

### **3.5.2 Clarifying the Boundary of the Gate**

The clarification of the doctrine 'would reduce ex ante uncertainty about whether an insurable interest exists in a given case, and it would thus reduce the perverse incentives that increase moral hazard and constrain the ability of insurers to take advantage of policyholders'.<sup>305</sup> This option nonetheless will not work well since the 'doctrine cannot escape the ambiguity inherent in the concept of 'insurable interest''.<sup>306</sup> Moreover, 'even a relatively modest amount of ambiguity in the insurable interest doctrine can create an incentive for insurers to accept higher levels of moral hazard or take advantage of policyholders'.<sup>307</sup> Loshin further argued that 'even if the doctrine could be made much clearer and more predictable, this result would inevitably make the insurable interest requirement more over-inclusive, and thus more likely to reduce the efficiency of the

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<sup>300</sup> *ibid* para 7.69.

<sup>301</sup> *ibid* para 7.70.

<sup>302</sup> *ibid* paras 7.73-7.75.

<sup>303</sup> *ibid* paras 7.76.

<sup>304</sup> *ibid* paras 7.77.

<sup>305</sup> Jacob Loshin 'Insurance Laws' Hapless Busybody: A Case Against the Insurable Interest Requirement' (2007) *The Yale Law Journal* 474, 499.

<sup>306</sup> *ibid* 501.

<sup>307</sup> *ibid* 501.

insurance market by invalidating insurance contracts where no intolerable moral hazard actually exists'.<sup>308</sup>

### 3.5.3 Insurer's Liability in Tort

If the insurer issues a policy where he knows that the policyholder did not enter through the gate, the insurer should be liable in tort. Many American states have already adopted the 'implied duty of fair dealing' in insurance contracts and they have interpreted this duty as creating a tortious cause of action against insurers who act in 'bad faith'.<sup>309</sup> Such duty prevents insurers from using the doctrine as a defence since they acted in bad faith by contracting with the insured whilst they knew that the insured did not enter through the gate.

Loshin argued that this would also not be able to stop the insurers from the moral hazard that he identified due to the ambiguity in the doctrine. He said that insurers 'can use ambiguity in the insurable interest doctrine to argue that they were in fact acting in good faith'.<sup>310</sup> It would be hard for the policyholders to prove bad faith since there are 'many questions related to insurable interest' that makes the issue 'fairly debatable'.<sup>311</sup> Where the issue is fairly debatable the courts resist bad faith actions.

### 3.5.4 Third Party Standing

In the US case *Secor v Pioneer Foundry Co*<sup>312</sup> Pioneer Foundry employed Jack Secor for a period of nine years, from 1954 to 1963. In March 1960, Pioneer Foundry acquired a \$50,000 key employee policy on Secor's life. Pioneer Foundry was the applicant, the owner, and the beneficiary of this life insurance policy, and paid all the premiums on the policy. Secor's employment relationship with Pioneer Foundry terminated in July of 1963, and Secor subsequently died in April of 1964. Secor's widow argued that 'after the termination of Secor's employment[,] Pioneer Foundry lost whatever insurable interest it had in Secor's life[,] and that a constructive trust should be impressed on the proceeds in favor of Secor's widow and estate'.<sup>313</sup> As Swisher stated, '[a]lthough other courts have been receptive to this

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<sup>308</sup> *ibid* 501.

<sup>309</sup> Roger C. Henderson, 'The Tort of Bad Faith in First-Party Insurance Transactions: Refining the Standard of Culpability and Reformulating the Remedies by Statute' (1992) 1 U. Mich. J.L. Reform 1, 26-30; See also, Ben Kingree and Loise Tanner, 'Life Insurance as Motive for Murder' (1994) Tort & Insurance L.J. 761,764.

<sup>310</sup> Jacob Loshin 'Insurance Laws' Hapless Busybody: A Case Against the Insurable Interest Requirement' (2007) The Yale Law Journal 474, 502.

<sup>311</sup> *ibid* 502.

<sup>312</sup> 173 N.W.2d 780 (Div. 2, 1969).

<sup>313</sup> *ibid* 781.

logical and legally sound argument, the Michigan Court of Appeal was not persuaded in this particular case',<sup>314</sup> and argued that the decision was based on 'unsubstantiated and erroneous assumptions'.<sup>315</sup> He said that the life insurance policies 'affect the named insured, the policy owner (when the policy is on the life of another), any contingent or secondary beneficiary, and any other equitable third-party beneficiary, such as the estate of the insured'.<sup>316</sup> Accordingly, the court was wrong preventing the widow who had interest in the contract from challenging the lack of insurable interest.<sup>317</sup> He suggested that 'any contingent beneficiaries and other third-party beneficiaries, such as the estate of the deceased insured, should also have standing to challenge the lack of an insurable interest in the life of the insured when appropriate'.<sup>318</sup> In such case the equitable remedy would be:

to compensate the policy owner for the time he or she actually had an insurable interest in the life of another by allowing the policy owner to recover the policy's case surrender value as of the date of the termination of his or her insurable interest, plus any premiums paid after that date, and award the remainder of the policy proceeds to the contingent beneficiary or to the estate of the insured as the party who had actually suffered loss at the time of the insured's death.<sup>319</sup>

However, many courts rejected such an approach since it violates 'privity of contract' principles by allowing the insurance contract to be challenged by someone who is not a party to it.<sup>320</sup> Loshin submitted that 'If the party entitled to the insurance payout under the contract did not have a hand in causing the person's death, third-party standing would take the insurance payout from the innocent party and transfer it to the estate of the deceased. Third-party standing would thus punish the innocent and give a windfall gain to the undeserving'.<sup>321</sup>

### **3.5.5 Requiring the Insured to Use the Gate both for Entry and Exit**

Under this option, the insured must have an insurable interest at the time of taking policy and at the time of claim. This option will change the life policy alike indemnity policies. Swisher argued that 'all business-related life insurance policies – including business partnerships, key

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<sup>314</sup>Peter Nash Swisher, 'The Insurable Interest Requirement for Life Insurance: A Critical Reassessment' (2005) 53 Drake L. Rev 477, 533.

<sup>315</sup> *ibid* 534.

<sup>316</sup> *ibid* 534.

<sup>317</sup> *ibid* 534. See also Robert H Jerry II, *Understanding Insurance Law* (4<sup>th</sup> edn, LexisNexis, 2007) 328.

<sup>318</sup> *ibid* 534; See also, Robert E. Keeton and Alan J. Widiss, *Insurance Law* (Practitioner's edn, 1988) 157-58.

<sup>319</sup> *ibid* 535-6.

<sup>320</sup> See, *Hicks' Estate v Cary*, 52 N.W. 2d 351 (Mich. 1952).

<sup>321</sup> Jacob Loshin 'Insurance Laws' Hapless Busybody: A Case Against the Insurable Interest Requirement' (2007) The Yale Law Journal 474, 503.

employees, creditor-debtor relationships, and other commercial interest with a substantial economic interest in the life of another' should be treated as 'contracts of indemnity that require a valid insurable interest both at the time of the policy inception and also at the time of the insured's death'.<sup>322</sup> He argued that this option should be applied 'to avoid the unwelcome – but very real – possibility of pernicious wagering contract on the life of the insured'.<sup>323</sup> He submitted that where the key employee left the job after the insurance policy was taken on his life, his former employer would have 'everything to gain, and nothing to lose' if he would 'suddenly die as a result of a mysterious and unfortunate "accident"'.<sup>324</sup> To overcome these problems of gambling and moral hazard Swisher recommended<sup>325</sup> to apply the proposals given by Professor William Vukowich that in 'addition to requiring an insurable interest at the inception of the policy, (1) a policy owner must have an insurable interest at the time of the insured's death; and (2) a policy owner may recover the cash surrender value of his policy as of the date of the termination of his insurable interest plus any premiums paid after that date'.<sup>326</sup>

The proposal is aimed at reducing the wagering and moral hazard by the insureds but can do nothing to reduce the moral hazard by the insurers as identified earlier. The proposed law will further encourage insurers to issue policies when they have doubt in the existence of insurable interest at the outset since the insurer will not have to pay anything if the interest does not exist after the commencement of the policy or would pay less if the interest decreases at the time of death. For example, the insurer doubts whether A has entered through the gate or not. If insurer issues the policies he will have a good chance to argue that the contract is illegal for not entering through the gate. However, according to current law, there is a risk that he has to pay the full claim if it is established that A has entered through the gate, whereas, according to the proposals, the insurer has the further option of either stopping A from recovering the insured amount by showing the lack of interest at the time of death, or

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<sup>322</sup> Peter Nash Swisher, 'The Insurable Interest Requirement for Life Insurance: A Critical Reassessment' (2005) 53 Drake L. Rev 477, 531.

<sup>323</sup> *ibid* 529-31.

<sup>324</sup> *ibid* 528. Peter Nash Swisher stated a true story in the footnote no. 255 of this article in this regard. He said that 'one of my law students told me of a similar situation involving his father who had a bitter argument with his business partner and left the business. There were similar key man life insurance policies on his father's life owned by the business ... Subsequently, my student's father was almost killed in two separate near-miss automobile hi-and-run incidents and the family had to relocate to another city to ensure his father's safety. No evidence ever linked these two incidents to his father's business partner, but his life remained in jeopardy.'

<sup>325</sup> *ibid* 524.

<sup>326</sup> William T. Vukowich, 'Insurable interest: when it must exist in property and life insurance' (1971)7 Willamette LJ 1, 36.

pay out a lesser amount by arguing that the interest has reduced at that time. Consequently, the opportunity of gambling by the insurer using insurance policies will be increased by the proposed law.

Further to that, making the life policy an indemnity policy will cause injustice to the insured. Parke B said in *Dalby v India and London Life-Assurance Co* that

life-assurance...is a mere contract to pay a certain sum of money on the death of a person, in consideration of the due payment of a certain annuity for his life, - the amount of the annuity being calculated, in the first instance, according to the probable duration of the life: and, when once fixed, it is constant and invariable. The stipulated amount of annuity is to be uniformly paid on one side, and the sum to be paid in the event of death is always...the same, of the other. This species of insurance in no way resembles a contract indemnity.<sup>327</sup>

The injustice can be further highlighted in the following two comparative examples. In an indemnity policy, an insured like D can get a replacement product if the insured product is damaged within the policy period. He may receive a further replacement if that replaced product breaks down within the policy period without being required to pay higher premiums. By contrast, a life policy taken on the life of a debtor is concluded, under this proposal, once the debt amount is repaid. Here, the insured of the life policy is not enjoying the benefit of security for one year, whilst he paid the fixed premiums calculated on the basis of the security for that period. Whereas, D is enjoying the support that he is paying for. Accordingly, the insured of the life policy is being treated unfairly.

### **3.5.6 Requiring the Insured to Use the Gate Only at the Time of Exit**

This will also make the life policy an indemnity policy. Consequently, this will also carry the same problem that has been identified in the last point. However, some of those problems will be more dangerous in this case. For example, in the previous option the insured was only allowed to insure the amount equivalent to the value of his interest, but in this case he is allowed to insure any higher amount that he likes leading to high premiums. Whilst he is paying high premiums for the security of a certain period, he will lose that service if the interest is lost before the end of that period.

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<sup>327</sup> (1854) 139 ER 465, 474.

### 3.5.7 A New Approach

An insurer owns the premises and an insured enters into that premises to get a contract. Common sense suggests that it should be the duty of the insurer to check whether that insured is entering his premises through the proper gate or not. Usually, the insured makes an application to the insurer who decides whether or not to issue the policy. Consequently, it should be the responsibility of the insurer to check whether the insured is eligible to be insured by checking whether he entered through the right gate. Whereas, the current law says that it is the duty of the insured to enter through the right gate and as such the insurer does not bother whether the insured is eligible to take the policy or not. This approach causes serious problem for lay insureds who do not know about the gate, the criteria in order to be eligible for a valid policy. Hence, many insureds get confused and enter through the wrong gate. The current law says that these contracts are illegal and it is seemed to be unfair for the insureds.

Consequently, it is recommended that *an insurer should have the duty to take reasonable steps to ensure that the insured has sufficient insurable interest to enter into the contract. The insurer shall also take reasonable steps when determining the value of interest that can be insured. If the insurer fails to take reasonable steps and it is found that the insured did not have insurable interest, the contract is void and the insurer shall pay the premiums back with judgment rate interest<sup>328</sup> from the day of taking policy till the day of returning premiums. If the insurer takes a policy for more than the actual interest breaching his duty of taking reasonable steps in determining the value of interest, he shall repay the excess premiums received for that excess coverage, with judgment rate interest<sup>329</sup> back to the insured. The rest of the policy will still be valid. If the insurer finds the existence of interest after taking reasonable steps whilst there was no insurable interest, the policy shall be void and the insurer has to pay the premiums back without any interest. Similarly if he takes the policy for a larger amount than the actual value of interest even after taking reasonable steps, he would repay the excess premiums back to the insured without any interest.*

This approach shall prevent the insurer from taking advantage of mistakes that lay people make when finding the right gate, and as such will reduce moral hazards from both the point of view of the insured and insurer. The insurer shall also not benefit from issuing policies for

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<sup>328</sup> Currently 8% by way of Judgments Act 1838.

<sup>329</sup> From the day of taking policy till the day of return



more than the actual interest since they would have to repay any excess premiums for excess coverage with interest. This remedy is fair for both parties in the sense that the insured shall receive the insured money that he should get from his valid interest in the life and also receive the excess amount that he paid due to the fault of the insurer with judgment rate interest. The insurers will not find it unfair since they are paying back the amount that they should not have taken but for their own fault, and paying the judgment rate interest on that amount is reasonable in every sense. Since it is the duty of the insurer to decide whether the proposed policyholder has got the insurable interest, the law can allow a wide definition of insurable interest. For example, in the US, insurable interest is defined as ‘there must be a reasonable ground, founded upon the relations of the parties to each other, either pecuniary or of blood or affinity, to expect some benefit or advantage from the continuance of the life’ that is insured.<sup>330</sup>

It is the insured who knows better when his purpose of entry into the premises is over. Consequently, it should be his duty to leave the premises i.e. inform the insurer when the interest ceases to exist. For example, a father has promised to pay for educational expenses of his son. The son has taken a policy on his father’s life for the amount that he needs to complete the course. If he fails to succeed in the course and is no longer allowed to proceed, the insurer shall know nothing unless the insured informs him. The author, therefore, recommends that *the policy shall lapse once the insurable interest is over and the insured must inform the insurer within a reasonable period. If he fails to inform and continues paying premiums, the insurer shall pay these premiums back deducting the sum equivalent to the judgment rate interest from the day the policy lapsed till the day they have been informed.* For example, the insured paid £5,000 as premium after the policy lapsed for lack of insurable interest. The insurer will pay this amount back deducting the sum equivalent to judgment rate interest from the day the policy lapsed till the day the insured informed him. The interest is imposed to compensate the insurer for continuing an invalid policy and for being deprived of taking another policy from the date when the policy lapsed.

Where the interest is not over but reduced, the law can take any of the following approaches. They can require the insured to inform the insurer about the reduction of interest and amend the contract with reduced premiums, or they can let the insured continue the contract without

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<sup>330</sup> *Warnock v Davis*, 104 U.S. (1881) 775, 779.

any change and require the insurer to pay full claim treating it a contingent policy or finally, they can treat the policy as an indemnity. However, the insured should be allowed to cancel the contract so as to give him the chance to enter into a new contract with lower premiums.

### **3.6 Remedy for Breach**

Under section 1 of the Life Assurance Act 1774 policies made without insurable interest are null and void. Subsequently, the courts established that such policies are illegal.<sup>331</sup> Where a contract is illegal, the policyholder will not be able to claim the insured money nor will he be able to claim his premiums back unless he can establish that the insurer bears a greater degree of responsibility for that illegal contract.<sup>332</sup>

However, the remedy has been criticised for being unnecessarily harsh. The Insurance Ombudsman said in the Insurance Ombudsman Bureau Annual Report for 1989 that he would not hold the policies without insurable interest illegal but void and premiums would be returned. The Law Commission also proposed similar reforms.<sup>333</sup> However, the author has recommended a new kind of duty and as such the remedy should be in a different form, which has also been recommended above.

### **3.7 Insurable Interest under Shariah Principles**

It has been discussed in the previous chapter that Shariah principles do not impose any specific rules related to insurance policy. Therefore, it is required to consider whether the current English law contradicts with Shariah principles. If it does not contradict, the law can be applied in Islamic policies. If it does contradict, the insurer has to take some measures so as to comply with both laws. The current position can be compared and contrasted with the law in Malaysia where a law for conventional insurance and a separate law for Islamic insurance operate simultaneously. The Insurance Act 1996, applied to conventional policies and section 152 of the Act imposes the requirement of insurable interest existing at the time of taking out the policy and at the time of peril. The Takaful Act 1984 does not contain any section related to insurable interest. The Report Committee, established in 1982 to discuss the enactment of the Takaful Act, suggested that the insurable interest should not be a requirement for family Takaful since the participants will only participate for the benefit of

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<sup>331</sup> *Harse v Pearl Life Assurance Co* [1904] 1 KB 558.

<sup>332</sup> *Hughes v Liverpool Friendly Society* [1916] 2 KB 482.

<sup>333</sup> Law Commission and Scottish Law Commission, *Insurance Contract Law: Issues Paper 4 Insurable Interest (Summary)* (14 January 2008) para 1.39

themselves and their families meaning that there is no scope of gambling and moral hazard.<sup>334</sup> However, Nusaibah Mohd Parid, argued that the possibility of moral hazard still exists and as such suggested for the requirement of insurable interest.<sup>335</sup> Further to that, the insurable interest shall work as a means to prevent evil like wagering and moral hazard and as such should be required in an insurance policy. This approach in Shariah is known as Sadd al-dhariah.

However, the academics are still divided in the necessity of the application of insurable interest.<sup>336</sup> Since English law imposes the requirement of insurable interest, the views of the academics who support the requirement of insurable interest in Islamic policies are only relevant for this research. Dr Mohd Ma'sum Billah proposed that the contract shall be void if the policyholder does not have 'insurable interest legally, morally or spiritually' in the life insured at the time of taking policy.<sup>337</sup> This proposal shall allow policyholders to take policies on persons in whose lives they have a moral or spiritual interest making the door too wide, meaning that the requirement will certainly fail to prevent wagering and moral hazard for the reasons that discussed above. Further, insurance companies will have further opportunities to engage with moral hazard as analysed above. Nusaibah Mohd Parid suggested that insurable interest should be required to exist both at the time of inception and at the time of claim to prevent gambling and moral hazard.<sup>338</sup> She recommended that the payment shall be made as 'compensation for a real loss or burden sustained by the participant due to the peril and not merely due to the occurrence of the peril',<sup>339</sup> meaning it is an indemnity policy. In her view if the policy is a contingency policy, the policyholder shall be able to receive more than the actual loss which would cause an unfair result for other participants in the 'takaful pool' and encourage gambling and moral hazard.<sup>340</sup> However, she found it difficult to quantify the loss for the death of the life insured and pay accordingly. For example, if it is said that a father has insurable interest on his child, then the question is, what financial loss will he suffer due to

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<sup>334</sup> See, Nik Ramlah Mahmood, 'The Islamic System of Mutual Insurance: the Malaysian Experience' (1991) 6(3) Arab Law Quarterly 280, 293; Nusaibah Mohd Parid, 'Insurable Interest in Takaful Practices: an Analysis', (2009) 3 ISRA Research Paper 1, 5.

<sup>335</sup> Nusaibah Mohd Parid, 'Insurable Interest in Takaful Practices: an Analysis', (2009) 3 ISRA Research Paper 1, 5-6.

<sup>336</sup> See *ibid* 6.

<sup>337</sup> Dr. Mohd. Ma'sum Billah, 'Insurable interest: can the modern law be adopted in Takaful operations?' (2000) Arab Law Quarterly 206, 207.

<sup>338</sup> Nusaibah Mohd Parid, 'Insurable Interest in Takaful Practices: an Analysis', (2009) 3 ISRA Research Paper 1, 5-6, 27.

<sup>339</sup> *ibid* 27.

<sup>340</sup> *ibid* 27-9.

the death of the child? She argued that, it would not be accepted to say that the father had lost the money that he spent for the child since it was his obligation to spend. Consequently, ‘the money really belongs to the recipient [child in this case] and not the provider [father]’<sup>341</sup>. As Allah (SWT) says –

ولا تقتلوا أولادكم من املاق- نحن نرزقكم و اباهم

*And do not kill your children because of poverty. We provide for you and for them.*<sup>342</sup>

The probable loss of future support by the child to the parents when they would be old can also not be calculated since probable future loss is not covered by the Shariah principles as it is uncertain.<sup>343</sup> Prophet Muhammad (PBUH) ‘forbade the sale with uncertainty in it’.<sup>344</sup> It is narrated from Anas ibn Malik that the Prophet Muhammad (PBUH) forbade selling fruit until it had become mellow. He was asked, ‘Messenger of Allah, what do you mean by become mellow?’ He said, ‘When it becomes rosy’. The Messenger of Allah (PBUH) added, ‘Allah may prevent the fruit from maturing, so how can you take payment from your brother for it’.<sup>345</sup> Similar rulings can be found in the following Hadith-

عَنْ نَافِعِ بْنِ عُمَرَ قَالَ : " كَانَ أَهْلُ الْجَاهِلِيَّةِ يَتَبَايَعُونَ لَحْمَ الْجُرُورِ إِلَى حَبْلِ الْحَبَلَةِ ، وَحَبْلِ الْحَبَلَةِ أَنْ تُنْتَجِجَ النَّاقَةُ مَا فِي بَطْنِهَا ثُمَّ تَحْمِلُ الْبَيْتَ تَنْجَتُ ، فَتَهَاهُمُ رَسُولُ اللَّهِ - صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ - عَنْ ذَلِكَ ،<sup>346</sup>

*Narrated by Ibn ‘Umar ‘In the pre-Islamic period of ignorance the people used to bargain with the meat of camels on the principles of habal-al-habala which meant the sale of a she-camel that would be born by a she-camel that had not yet been born. The Prophet (PBUH) forbade them such a transaction’.*<sup>347</sup>

In these circumstances she stressed in valuing a life,<sup>348</sup> but found no viable solution and as such left it open for the academics to make further suggestions.<sup>349</sup>

<sup>341</sup> ibid 32.

<sup>342</sup> *The Holy Quran*, 6:151.

<sup>343</sup> Nusaibah Mohd Parid, ‘Insurable Interest in Takaful Practices: an Analysis’, (2009) 3 ISRA Research Paper 1, 33.

<sup>344</sup> Imam Malik, *Muwatta*, (USC Centre for Muslim-Jewish Engagement tr, <<http://www.usc.edu/org/cmje/religious-texts/hadith/muwatta/031-mmt.php>>) Book 31, Number 31.8.11. Accessed 5 July 2013.

<sup>345</sup> ibid Book 31, Number 31.8.11.

<sup>346</sup> 419 فتح الباري شرح صحيح البخاري, كتاب البيوع- بيع الغرر- 419; Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari* 2039.

<sup>347</sup> Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari* (Dr. M Muhsin Khan tr) Vol 5, Book 58, Number 183.

<sup>348</sup> Nusaibah Mohd Parid, ‘Insurable Interest in Takaful Practices: an Analysis’, (2009) 3 ISRA Research Paper 1, 29-32.

### 3.8 Critical Analysis and Recommendation

Following the aforementioned analysis, it becomes clear that there are two phases to the rule relating to insurable interest, the time of inception of the contract and at the time of claim. Each of these parts are analysed below so as to find how the requirement of insurable interest should be applied in the Islamic policies following the Shariah principles.

#### *Time of inception*

The above discussion has made it clear that the requirement of insurable interest should exist at the time of inception. However, the calculation of the interest has to be accurate as no one can take the extra benefit from the Takaful pool. It will be an easy task to calculate the exact interest if it is based on financial obligation. For example, where the creditor insures the life of a debtor for the debt amount, which is £50,000, the loss for his death is clear. The difficulty is, however, in the calculation of the loss where the relationship is based on love and affection. The English law in these cases allow the insured to take policy for any amount he/she wants and with any number of insurers he/she likes. Hence, the notion creates an uncertain benefit for the insured as identified by Nusaibah Mohd Parid which is illegal under Shariah principles.<sup>350</sup> Further to that, this approach will encourage moral hazard. For example, if a husband insures the life of his wife for a large amount of money and subsequently starts disliking her or gets divorced, the large amount of insured money might encourage him to kill her or pray for her death. In such cases it is assumed that the policy on own life or the life of a loved one is not allowed. Whereas, Allah (SWA) says in the Quran

وتعاونوا على البر والتقوى ولا تعاونوا على الإثم والعدوان

*Help you one another in righteousness and piety.*<sup>351</sup>

He also says

واخفض جناحك للمؤمنين

*And lower your wings for the believers.*<sup>352</sup>

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<sup>349</sup> ibid 35-6.

<sup>350</sup> ibid 33. See also, Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari* (Dr. M Muhsin Khan tr) Vol 5, Book 58, Number 183.

<sup>351</sup> *The Holy Quran*, 5:2.

<sup>352</sup> *The Holy Quran*, 15:88.

Prophet Muhammd (PBUH) said

عن ابن هريرة رضى الله عنه عن النبي صلى الله عليه وسلم قال الساعى على الارملة والمسكين كالمجاهد فى سبيل الله واحسبه قال وكالقائم الذى لا يفتر ، وكالصائم لا يفطر

*Abu Hurairah (RTA) reported that The Prophet (PBUH) said, 'One who strives to help the widows and the poor is like the one who fights in the way of Allah'. The narrator said: I think that He (PBUH) added also: 'I shall regard him as the one who stands up (for prayer) without rest and as the one who observes fasts continuously'.<sup>353</sup>*

It is evident from these Quranic verses and Hadith that fellow Muslims should support the close relatives of the deceased. If the husband is the only earner of the family and he dies, the family needs financial support. In such circumstances the fellow Takaful participants can help through their contributed amount in the pool. Hence, the amount will be provided to the family of the deceased as a means of support not compensation.

The question then becomes, how much should the fellow participants of the Takaful provide the deceased's family? If the family was low earning, they must not live in an expensive house or drive an expensive car. On the other hand, a family with high income should have opposite life standards than that of the earlier one. If the Takaful participants provide a large amount of money to the low earning family, it would give them extra benefit for the death of the deceased. This can be categorised as an imbalance and unjust enrichment. On the other hand, if the Takaful participants provide a low amount to the latter family that support would mean nothing to them. Consequently, a balance is required. In the author's view the balance can be created by limiting the amount that a person can insure his/her own life or the life of their spouse for the amount equivalent to his/her past five-year income. The person can insure for fewer amounts but cannot exceed the limit. If the person is dependent, he should calculate the earnings of the person on whom he is depending. If the family has two or more earners and the whole family survives on that total earning, the limit would be the amount equivalent to their past five-year income. This recommended amount will establish the certainty and a balance. Such balanced amount should reduce the attraction towards moral hazard.

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<sup>353</sup> Al-Imam Abu Zakariya Yahya Riyad-us-Saliheen, Vol 1, No 265 (cited from Sahih Bukhari and Muslim); Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari* (Dr. M Muhsin Khan tr) Vol 8, Book 73, no. 35.

It is now obvious that the English law allowing the insured to take policy for any amount on their own life or the life of a loved one contradicts with the Shariah principles. In such circumstances Islamic insurers should take special measures by incorporating adequate terms fixing the amount as suggested by the author. However, in some cases Islamic insurers shall have no escape route and has to obey the English law even if that contradicts Shariah principles. Such as, the current English insurance law does not allow any policy on parents' or child's life. The Islamic insurer will not be able to take those policies. Similarly, English law allows policy on civil partners, a relationship prohibited in Islam. The Islamic insurer will have to take the policy if any partner claims to be insured by them since English law does not allow sexual discrimination.

The author recommends that in English insurance law the insurer should have the duty to take reasonable steps to ensure the existence of insurable interest of the insured and assess their value. The same duty should be applied in the Islamic insurance contracts so as to save the innocent insured and stop the chance of gambling by the insurer. However, if the insurer fails to perform his duty and takes a policy where the insured does not have any interest or fewer interests than he actually insured for, the insurer will pay the excess premiums including a charge for keeping the insured out of pocket for a certain period. The charged amount should be equivalent to the amount paid under judgment rate interest from the day the policy is taken till the day the money is returned.

#### *At the Time of Claim*

Nusaibah Mohd Parid suggested that the insured should be allowed to receive only the amount that was equivalent to the interest that he had at the time of claim i.e. making the life policy an indemnity policy.<sup>354</sup> The effect of this proposal can be best explained by the following example, X insures the life of his debtor Y for the debt amount which is £60,000. If Y pays X £50,000 before his death, X should be allowed to get £10,000 from the Takaful pool after the death of Y. There are two problems with this approach. X has taken out a policy for £60,000 and promised to contribute to the Takaful pool by way of premiums each month, which is £500. It will be unfair for X to be required to pay the same premiums after receiving £50,000 from Y if he is allowed to obtain only £10,000 from the Takaful pool after Y's death. The second problem is that current English law says that the life policy is a

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<sup>354</sup> Nusaibah Mohd Parid, 'Insurable Interest in Takaful Practices: an Analysis', (2009) 3 ISRA Research Paper 1, 27.

contingency policy where the insured shall receive the full insured amount regardless of the amount or existence of his interest at the time of claim.

Both of these problems can be solved by incorporating a term allowing the parties to amend the contract whenever it is necessary. Whenever the interest of X is reduced it shall be his responsibility to contact the insurer so as to change the insured amount and the premiums. For example, after receipt of the £50,000 the policy shall be amended so as to cover £10,000 and the premiums shall be reduced accordingly from the day of receipt of that £50,000. Once Y dies, X shall receive £10,000 from the insurer complying with both the English law and Shariah principles. If X fails to inform the insurer so as to amend the contract and premiums, the insurer will pay the excess premiums to X, taken from the day of receipt of that £50,000, back charging an administrative cost equivalent to the amount paid under judgment rate interest on £50,000 from the day the risk is reduced to £10,000 till the day the insurer is informed.

It is now evident that in this part of the contract English law cannot accommodate Shariah principles due to the operational difference between these two categories of policies. In the case of Islamic policies, the fellow insureds cooperate with the insured in question by paying the money that he has suffered due to the peril. Consequently, it would be an injustice for them to be required to pay more than the actual sufferings. Whilst the former considers the policy as a contractual relationship between the insured and insurer, where the insurer is contracted to pay a certain amount upon the death of the life insured in return for fixed premiums. Consequently, Islamic insurers have to take special measures by incorporating adequate terms so as to make the policies of English and Islamic law compliant.

### **3.9 Conclusion**

Both English insurance law and Shariah principles intend to prevent gambling and moral hazard. Accordingly, the approach of English insurance law appears to be supported by the latter law as long as the approach successfully prevents those two activities. The English law has imposed the requirement of insurable interest, but it is found to be unworkable since the door of gambling and moral hazard still remain open. Consequently, some academics consider that the requirement is useless and recommended its abolition following Australia. They argue that the Gambling Commission and FSA are sufficient to distinguish between gambling and insurance contracts and the police force and Criminal Acts are sufficient to



prevent the moral hazard. The Law Commission supported this view, but found that people are afraid of being insured by others who do not like them, using a policy as a threat or as a coercive tool. In addition to this, the author argues that relying on police and the criminal law leaving the opportunity for gambling and moral hazard is not a wise approach. However, the Law Commission provisionally proposed to keep the requirement of insurable interest and suggested to widen its boundary. It is apparent that they are not sure about the value of this recommendation but failed to find a better solution. There are several possible solutions identified by the academics, but all of them are unsuccessful in preventing gambling and moral hazard.

The author has recommended a brand new approach where the insurer is required to take reasonable steps to ensure that the insured has got insurable interest at the time of taking policy. If the insurer fails to perform his duty and it is subsequently discovered that there was no insurable interest, the policy shall be void and the insurer will pay the premiums back with judgment rate interest from the day of taking policy until the day the money is returned. This approach reduces the possibility of gambling and moral hazard from the insurer's part and also saves many innocent insureds. However, the policy shall lapse once the interest ceases to exist during the policy. In such a case it is the duty of the insured to let the insurer know about it and stop paying the premiums. If he fails to do so and continues paying premiums, the insurer shall pay these premiums back deducting the amount equivalent to judgment rate interest from the day the policy lapsed till the day when he was informed. This duty and remedy will allow the insured to enjoy the legitimate benefit from the policy and significantly reduce the chance of gambling and moral hazard. However, the boundary of the requirement has to be extended in some cases so as to allow some people who have legitimate interest on the life insured to take the policy. The English law allowing the insured to take out a policy on own life or on the life of their spouse or civil partner for any amount contradicts Shariah principles. There is no invented model that could be found in this aspect that can make such contract Shariah compliant. The author has suggested a new method which should comply with Shariah principles. In order to avoid contradiction with the English insurance law, the Islamic insurers should incorporate certain terms so as to apply the author's recommendation to make the policy compliant with both English law and Shariah principles.

## Appendix

Following the strong support from the respondents of Issues Paper 4 the Law Commission in the Consultation Paper No 201, published in December 2011, proposed to retain the requirement of insurable interest. They proposed that ‘an insurable interest may be found where the proposer has a real probability of economic loss on the death of the person insured’.<sup>355</sup> ‘The amount of the insurance must be reasonable given the likely loss that the proposer will suffer’.<sup>356</sup> The amount ‘would be assessed at the time of the contract,’ and the parties would have discretion in reaching the valuations. They proposed three limited extensions to the insurances based on ‘natural affection’. They proposed that the parents and the people who treat a child under 18 as a child of the family should be entitled to take out insurance on the life of that child with a cap on the amount that can be insured. The Law Commission asked the respondents to share their views on the amount that can be insured and on how it should be set.<sup>357</sup> The second group that should be included within the extensions is ‘cohabitants’. They proposed that the cohabitants should be ‘entitled to insure each other’s lives on the basis of a real probability of economic loss’.<sup>358</sup> Where they have lived in the same household as spouses or civil partner ‘during the whole of the period of five years ending immediately before the contract of life insurance is taken out’ they should be eligible to insure each other’s lives irrespective of whether they can show economic loss.<sup>359</sup> The third group is the ‘trustees of pension or group schemes’. The Law Commission raised the question for consultees to suggest whether the trustees of pension and other group schemes should have unlimited interest in the lives of the members of the scheme and employers who have entered into a group scheme whose purpose is to provide benefits for its employees or their families should have unlimited interest on the lives of those employees.<sup>360</sup>

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<sup>355</sup> The Law Commission and the Scottish Law Commission, *Insurance Contract Law: Post Contract Duties and Other Issues* (Consultation Paper No 201, Discussion Paper No 152, 2011) para 13.71.

<sup>356</sup> *ibid* para 13.73.

<sup>357</sup> *ibid* para 13.82.

<sup>358</sup> *ibid* para 13.95.

<sup>359</sup> *ibid* paras 13.101, 13.103.

<sup>360</sup> *ibid* paras 13.106-13.107.

## Chapter 4 – Pre-Contract Duty

### 4.0 Introduction

There is no specific legislation that applies to general insurance contracts. The courts therefore follow the sections of Marine Insurance Act 1906 that are applicable to such contracts. Section 17 of the Act is accepted to be applicable for the duty of the insured and insurer before entering into the general insurance contract. The section imposed a duty on both the insured and the insurer to act with utmost good faith. Section 18 requires that the insured disclose every material fact before taking a policy. The section states that ‘every circumstance is material which would influence the judgment of a prudent insurer in fixing the premium, or determining whether he will take the risk.’ It is argued that it is obviously hard for a layman to know how a prudent insurer thinks and what should affect his decision. Consequently, this duty is unreasonable for the insured. Further, section 18 does not impose any specific duty of disclosure on the insurer. The courts, therefore, rely on section 17 which imposes the duty to act with utmost good faith. Under this section, it is submitted that, the courts do not impose any mentionable duty of disclosure on the insurer so as to help the insured in choosing the right insurer for the security against the danger that he is predicting. Consequently, the duty imposed on the insurer causes unfair consequences for the insured. For example, Drake Insurance plc went into liquidation due to taking out policies for more than their capacity.<sup>361</sup> Had the insured known of the poor capacity of Drake Insurance plc, it is assumed, that they would not have taken out any policies with them risking their insurance cover. Consequently, it is argued that, the law is favouring the insurer not the insured.

In order to make the duty fairer for the insured the Government has introduced a Bill<sup>362</sup> on their duty of disclosure based on the recommendations of the Law Commission. The recommended duty, on the other hand, is found to be favouring only the insured not the insurer. Consequently, it is argued that these proposals do not strike the expected fair balance between the parties. If the right balance is not struck, the Islamic policies cannot be applied

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<sup>361</sup> See, FSA/PN/057/2000 released on 09/05/2000

<<http://www.fsa.gov.uk/Pages/Library/Communication/PR/2000/057.shtml>> accessed 5 Feb 2010; FSA/PN/060/2000 released on 12/05/2000

<sup>362</sup> Consumer Insurance (Disclosure and Representations) HL Bill (2010-2012) 68. It has come into force as an Act being entitled ‘Consumer Insurance (Disclosure and Representations) Act 2012’ on 6 April 2013 without any change to the sections that are referred in this thesis. Since the original text was completed on 1<sup>st</sup> December 2011 the Bill is referred instead of the Act.

under that rule. Hence the thesis will recommend a better solution for English insurance law in establishing the required fairness between the insured and insurer. Once a balanced duty is established, the application of Islamic policies in the English legal system would not be hindered.

#### **4.1 The Current Law**

Whilst section 17 imposed a general duty for both the insured and insurer to act with utmost good faith, section 18 specified the duty of a consumer insured by imposing the requirement of disclosure of ‘every material circumstance which is known’ to him.<sup>363</sup>

The term ‘material circumstance’ has also been explained by section 18, which is a fact that ‘would influence the judgment of a prudent insurer in fixing the premium, or determining whether he will take the risk.’ The section says that whether a particular circumstance is material or not is purely ‘a question of fact.’

#### **4.2 Explanation of the Law by the Courts**

The courts have explained the law from several parts a) when the material fact must be disclosed; b) what must be disclosed and c) what constitute material fact.

##### **4.2.1 When the Material Fact must be Disclosed**

In *Lynch v Dunsford*,<sup>364</sup> Lord Ellenborough C.J. held that the duty requires the insured to disclose the material facts within his knowledge at the time of affecting the policy. He does not have any duty to disclose the subsequent events.

##### **4.2.2 What must be Disclosed?**

The court in *Economides v Commercial Union Assurance Co plc*<sup>365</sup> held that a private individual has to disclose only the facts that are known to him. Accordingly, provided that he did not wilfully shut his eyes to the truth, the only obligation is was that of honesty and there is no requirement to inquire further into the facts.

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<sup>363</sup> Regarding business insurance, section 18 states that the insured ‘is deemed to know every circumstance which, in the ordinary course of business, ought to be known by him’. Since the current research is only based on consumer insurance, the duty related to business insurance will not be discussed.

<sup>364</sup> (1811) 14 East 494, 497.

<sup>365</sup> [1998] QB 587.

### 4.2.3 What Constitutes A Material Fact?

There is a long history of argument on the point of what actually constitutes a material fact, which must then be disclosed. The latest development of the law is as stated by the House of Lords in *Pan Atlantic Insurance Co Ltd v Pine Top Insurance*,<sup>366</sup> where a 3-2 majority of the House, approving the *CTI* case,<sup>367</sup> held that the test of materiality of disclosure for the purposes of both marine insurance under section 18 of the 1906 Act and non-marine insurance was, on the natural and ordinary meaning of section 18, whether the relevant circumstance would have had an effect on the mind of a prudent insurer in weighing up the risk, not whether had it been fully and accurately disclosed it would have had a decisive effect on the prudent underwriter's decision whether to accept the risk and if so, at what premium.

They rejected the application of decisive influence test since that would cause great practical difficulties for the court after the event to determine what type of underwriting decision a prudent insurer would have taken in the circumstances.<sup>368</sup> Soyer commented that 'the difficulties that a court could face in applying the decisive influence have been overstated... This does not pose any difficulty as long as the court has means of gathering sufficiently independent data from third parties...'.<sup>369</sup> A further criticism against the decisive influence test was made by Lord Mustill who stated that it fails to take into account the impact of the actual underwriter, who through laziness, incompetence or a simple error of judgment, entered into a bargain which no prudent underwriter would have made.<sup>370</sup> In reply to this point Soyer argued, that the 'inducement requirement, which has been imported into insurance law from general contract law... can certainly address the anomaly detected by Lord Mustill'.<sup>371</sup> Lord Templeman said, 'materiality must be judged by the reactions of a prudent insurer, otherwise the actual underwriter could, after the risk has matured, convince himself and the court that he would have rejected the risk or increased the premium if full disclosure had been made in the course of the negotiations.'<sup>372</sup>

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<sup>366</sup> [1995] 1 AC 501 (Lord Templeman and Lord Lloyd dissented).

<sup>367</sup> [1984] 1 Lloyd's Rep 476.

<sup>368</sup> *Pan Atlantic Insurance Co Ltd v Pine Top Insurance* [1995] 1 AC 501, 531 (Lord Mustill).

<sup>369</sup> B. Soyer, 'Reforming pre-contractual information duties in business insurance contracts - one reform too many?' (2009) 15 JBL 38.

<sup>370</sup> *Pan Atlantic Insurance Co Ltd v Pine Top Insurance* [1995] 1 AC 501, 532 (Lord Mustill).

<sup>371</sup> B. Soyer, 'Reforming pre-contractual information duties in business insurance contracts - one reform too many?' (2009) 15 JBL 38.

<sup>372</sup> *Pan Atlantic Insurance Co Ltd v Pine Top Insurance* [1995] 1 AC 501, 515.

In subsequent cases all the courts followed this majority view. In *St. Paul Fire & Marine Insurance Co v McDonnell Dowell Constructors Ltd*,<sup>373</sup> the Court of Appeal agreed with Lord Mustill's view<sup>374</sup> that the insured must disclose 'all matters which would have been taken into account by the underwriter when assessing the risk'.<sup>375</sup> In *Insurance Corporation of the Channel Islands v Royal Hotel*<sup>376</sup> Mance J held that 'it was a question of fact and degree and so of expert evidence whether any particular act of dishonesty was one which a prudent underwriter would take into account when assessing the risk.' However, Mr. Justice May held that the insurer is required to prove the materiality on balance of probability.<sup>377</sup>

#### 4.2.4 Inducement Test

Beside the requirement of disclosure of material fact, the court in *Pan Atlantic Insurance Co Ltd v Pine Top Insurance*<sup>378</sup> provided the insured a safety key which is termed as 'inducement' test. The insurer will not be able to avoid the contract if the insured can prove that the non-disclosure did not induce the insurer to enter into the contract 'on relevant terms'.<sup>379</sup> Since the issue related to the test of 'inducement' comes when the duty is breached in order to affect the remedy of the insurer it will be analysed in the next chapter where the remedy for breach of the duty is discussed.

#### 4.3 Criticism of the Current Law

The current law has imposed a huge burden on the insured to disclose every material fact. The reason for such approach can be found in the judgement of Lord Mansfield, where he said,<sup>380</sup>

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 assured 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. The keeping back such circumstance is a fraud... Although the suppression should happen through mistake, without any fraudulent intention, yet still the underwriter is deceived... because the risk run is really different

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<sup>373</sup> [1995] C.L.C. 818

<sup>374</sup> *Pan Atlantic Insurance Co Ltd v Pine Top Insurance* [1995] 1 AC 501, 538 (Lord Mustill)

<sup>375</sup> [1995] C.L.C. 818, 825 (Evans LJ).

<sup>376</sup> [1998] Lloyd's Rep IR 151.

<sup>377</sup> *March Cabaret v London Assurance* [1975] 1 Lloyd's Rep 169, 176

<sup>378</sup> [1995] 1 AC 501.

<sup>379</sup> See, *Drake Insurance plc v Provident Insurance plc* [2003] EWHC 109 (Comm), [2003] Lloyd's Rep IR 781; *Fraser Shipping Ltd v Colton* [1997] 1 Lloyd's Rep 586.

<sup>380</sup> *Carter v Boehm* (1766) 97 E.R. 1162, 1164.

from the risk understood and intended to be run at the time of the agreement...

The view of Lord Mansfield is correct, but the question is how much an insured is expected to disclose? The parameter to measure the accuracy of his disclosure is said to be the mind of a prudent insurer. Hence, the question is how does the court expect that a layman shall be able to realize that a certain circumstance shall affect on the mind of a prudent insurer<sup>381</sup> whereas the court itself cannot decide by its own and needs to rely on expert evidence?<sup>382</sup> It is also not viable to expect that an insured shall consult an expert before taking policy for reasons of cost and privacy. Few would desire to disclose every fact of their lives to an expert to find the *material fact* that has to be disclosed. Even if someone does, they still have the risk of the expert's report being refused.<sup>383</sup> The Law Commission, therefore, said in criticising the current law that 'an honest and reasonable insured may be quite unaware of the existence and extent of this duty, and even if he is aware of it, he may have great difficulty in forming any view as to what facts a prudent underwriter would consider material'.<sup>384</sup> Consequently, it is argued that the current law is unreasonably harsh and should be changed.

It is further to be noted that the insurer is in better position in obtaining the expert's opinion to refuse a claim. As a commercial organization the insurer may employ an expert to examine the contracts for which the claims are made. Though the expert opinion is not binding for the court, but it may persuade the court's decision. Accordingly, it is argued that, the duty of disclosure by the insured can be used as a trap by the insurer.<sup>385</sup>

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<sup>381</sup> The Law Reform Committee said that 'a fact may be material to insurers... which would not necessarily appear to a proposer for insurance, however honest and careful, to be one which he ought to disclose.' Law Reform Committee, *Conditions and Exceptions In Insurance Policies*, (5<sup>th</sup> Report, 1957) para 4.

<sup>382</sup> In *Insurance Corporation of the Channel Islands v Royal Hotel* [1998] Lloyd's Rep IR 151, Mance J agreed with the view of Fisher J in *Gate v Sun Alliance Insurance Ltd* [1995] LRLR 385 (High Court of New Zealand), 407 that it was a matter of expert evidence, along with the question of fact and degree, to decide whether the prudent underwriter would have taken into consideration the particular act of dishonesty in weighing up the risk.

<sup>383</sup> On several occasions judges disregarded the expert evidence coming from the industry. For instance, in *Roselodge Ltd (formerly Rose Diamond Products Ltd) v Castle* [1966] 2 Lloyd's Rep 113, 132 McNair J was not prepared to accept the testimony of an expert witness acting for the Lloyd's underwriter. See also *Reynolds v Phoenix Assurance Co* [1978] 2 Lloyd's Rep. 440.

<sup>384</sup> Law Commission, *Insurance Law - Non-Disclosure and Breach of Warranty*. (Law Com. No.104. Cmnd. 8064, 1980) para.9.3. See also, Law Reform Committee, *Conditions and Exceptions In Insurance Policies* (5<sup>th</sup> Report, 1957) para 4; R. A. Hasson, 'The Doctrine of Uberrima Fides In Insurance Law- A Critical Evaluation' (1969) 32 MLR 615, 628.

<sup>385</sup> See also, The Law Commission and The Scottish Law Commission *Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured - A Summary* (Consultation Paper No 182, Discussion Paper No. 134, 2007) para 9.

In the current market, insurance proposal forms are mostly completed on the internet with several questions being asked.<sup>386</sup> If there is any ambiguous question is asked in the form and the insured answers in the way that he realises, the current law shall allow the insurer to avoid the contract if his purpose of making the question is different<sup>387</sup> and he satisfies the inducement test.<sup>388</sup> The insured's honesty will make no difference to the court. It is interesting to note that the insurers take the issue of non-disclosure once a claim is made otherwise they ignore the point. It certainly proves the bad faith of insurer in the contract, yet the insured has nothing to do since the remedy provided by the law shall favour the insurer instead. In *Glicksman v Lancashire and General Assurance Co, Ltd*,<sup>389</sup> the insured answered 'No' in reply to the question 'Have you ever been refused insurance before?' This answer was correct if 'you' was in the plural sense, as the insured and his co-partner together were never refused by any insurance company. The answer was wrong if 'you' referred to singular sense, because the insured was previously refused by an insurance company when he was carrying on business alone. Lord Atkinson acknowledged that the question was vague,<sup>390</sup> nonetheless, affirming the decisions of Court of Appeal, held that the insurer can avoid the contract.<sup>391</sup> Fletcher Moulton LJ commented in *Joel v Law Union and Crown Insurance*,<sup>392</sup> that '... [t]hat duty, no doubt, must be performed, but it does not suffice that the applicant should bona fide have performed it to the best of his understanding.'

However, Fletcher Moulton LJ attempted to ease the burden on the insured holding that 'he should do it to the extent that a reasonable man would have done' and as such established reasonable assured test.<sup>393</sup> Subsequently, McNair J in *Roselodge Ltd v Castle*<sup>394</sup> held that Fletcher Moulton LJ's test of the reasonable assured was the correct test to be applied.

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<sup>386</sup> See, B. Soyer, 'Reforming the assured's pre-contractual duty of utmost good faith in insurance contracts for consumers: are the Law Commissions on the right track?' [2008] JBL 385, 392.

<sup>387</sup> See, *Glicksman v Lancashire and General Assurance Co, Ltd* [1927] AC 139.

<sup>388</sup> *Pan Atlantic Insurance Co Ltd v Pine Top Insurance* [1995] 1 AC 501.

<sup>389</sup> [1927] AC 139. See also, *Locker and Woolf v Western Australian Insurance Company* [1936] 1 K.B. 408; *Becker v Marshall* (1922) 11 Ll. L. Rep. 114; *Paxman v Union Assurance Society Ltd* (1923) 39 TLR 424; 15 Ll L Rep 206, 207 (McCardie, J); *Lee v British Law Insurance Co Ltd* [1972] 2 Lloyd's Rep 49, 57; *Berger v Pollock* [1973] 2 Lloyd's Rep. 442, 460 (Kerr, J.) where the existence of open cover could not relieve the plaintiff from avoidance; *Container Transport International Inc v Oceanus Mutual Underwriting Association (Bermuda) Ltd* [1984] 1 Lloyd's Rep 476, 525 (Stephenson, LJ); *Cf Gate v Sun Alliance Insurance Ltd* [1995] LRLR 385, 399 (Fisher J).

<sup>390</sup> *Glicksman v Lancashire and General Assurance Co, Ltd* [1927] A.C. 139, 144.

<sup>391</sup> R.A. Hason Commented in 'The Doctrine of Uberrima Fides In Insurance Law- A Critical Evaluation' (1969) 32 MLR 615, 623 'It is respectfully submitted that the House of Lords erred in this case by allowing the insurer to have the best of both worlds; this should not have been permitted even if the insured had been a person of greater sophistication than the illiterate tailor...'

<sup>392</sup> [1908] 2 K.B. 863, (C.A.), 884.

<sup>393</sup> *ibid*, 884.



However, the reasonable assured test suffered a fatal blow by the Court of Appeal in *Lambert v Co-operative Insurance Society Ltd.*<sup>395</sup> MacKenna J, delivering the leading judgment, reviewed the four possible tests of materiality, two of which were subjective and two objective, two were concerned with the views of the assured and two with the views of the insurer. He noted the authorities,<sup>396</sup> including the recommendation of the Law Reform Committee in 1957,<sup>397</sup> that were in favour of reasonable assured test. He further noted that, to his regret, the recommendation by the Law Reform Committee had not been accepted and he finally adopted the prudent underwriter test. The prudent underwriter test is now well-established law, possibly because it is ‘more difficult to identify the reasonable assured, given the differing locations, persuasions, professions and priorities of assureds around the world. It is much easier to describe the attitudes of the reasonable insurer’.<sup>398</sup> However, this reasoning is not acceptable on the ground that it will also be difficult identifying the reasonable insurer for the same reasons it is for the insured. Further to that there are cases where it is evident that two different insurers possess two different opinions.<sup>399</sup> Moreover, the duty on the insured ‘imposes a heavy and often unreasonable burden on the proponent who must possess near clairvoyant power to discover what a reasonable or prudent insurer would regard as material’.<sup>400</sup> Furthermore, the court itself has recognised that the duty is causing injustice to the insured.<sup>401</sup>

It is surprising that the law does not impose any mentionable duty on the insurer other than acting with utmost good faith. Further to that, the duty of acting with utmost good faith has not been defined. Consequently, the insurer is not under any duty to disclose any of their downsides. Whereas, it is argued that, the insured also has the right to know the insurer who he will take a policy with for a long period paying premiums with the hope of being compensated by that insurer at the time of loss. This is a question of trust, but a number of

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<sup>394</sup> [1966] 2 Lloyd’s Rep 113, 129-133.

<sup>395</sup> [1975] 2 Lloyd’s Rep 485.

<sup>396</sup> *ibid*, 491.

<sup>397</sup> A similar recommendation was made by the Law Commission *Non-Disclosure and Breach of Warranty* (Law Com No 104, 1980) para 4.47.

<sup>398</sup> Peter Macdonald Eggers, Simon Picken and Patrick Foss *Good Faith and Insurance Contracts* (2nd edn, LLP, 2004) para 14.22.

<sup>399</sup> See, *Hebdon v West* (1863) 3 B & S 579.

<sup>400</sup> C Larkin, ‘Uberrima Fides — Quo Vadis? Where to from Here?’ (1995) BLR 7(2) 18, referencing Tarr et al, *Australian Insurance Law*, (1991) LBC. See also Justice M Kirby, ‘Marine Insurance: Is the Doctrine of ‘Utmost Good Faith’ Out of Date?’ (1995) Aust Bar Rev 13(2) 1, 5.

<sup>401</sup> See, *Lambert v Co-operative Insurance Society Ltd* [1975]2 Lloyd’s Rep 485.

insureds take policy through agents and as such do not know who they are actually insuring with, how long they have been in business or what their financial position is. The following case exemplifies this point. On 9 May 2000 FSA announced by a press release that Drake Insurance Plc. has failed to maintain the required margin of assets over its liabilities and has failed to produce an adequate plan to remedy the situation<sup>402</sup> and as such went into provisional liquidation.<sup>403</sup> Hence, the argument is (as stated above), had an insured known the financial position of Drake before entering into a contract he certainly would not have taken the policy with them. Consequently, it is submitted that an insured also has the right to know the details of the insurer and as such the law should impose the duty on the insurer to disclose material information.<sup>404</sup>

The aforementioned analysis has made it clear that both the insured and insurer should have the duty of disclosure before making contract. Consequently, the following analysis will be divided into two parts: A) duty of the insured; B) duty of the insurer.

## **A) Duty of the Insured**

### **4.4 The Recommendations of the Law Commission**

The Law Commission in their consultation paper published in 2007 divided the duty of disclosure into two parts.<sup>405</sup>

Firstly, the duty of disclosure in business insurance. The Law Commission provisionally proposed to apply one law for all business insurances including marine insurance. The Commission proposed that to avoid the policy the insurer must show either:

- i) that a reasonable insured in the circumstances would have appreciated that the fact in question was one that the insurer would want to know about; or
- ii) that the proposer actually knew the fact was one that the insurer would want to know about.<sup>406</sup>

It is interesting to see that the Law Commission have proposed to adopt the similar rule, i.e. the reasonable assured test, that the Law Reform Committee proposed in 1957 but was

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<sup>402</sup> See the Ref: FSA/PN/057/2000 (9 May 2000)

<<http://www.fsa.gov.uk/Pages/Library/Communication/PR/2000/057.shtml>> accessed 5 Feb 2010.

<sup>403</sup> See the Ref: FSA/PN/060/2000 (12 May 2000)

<<http://www.fsa.gov.uk/Pages/Library/Communication/PR/2000/057.shtml>> accessed 5 February 2010.

<sup>404</sup> The category of 'material information' will be discussed below.

<sup>405</sup> The Law Commission and The Scottish Law Commission *Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured – A Summary* (Consultation Paper No 182, Discussion Paper No. 134, 2007) para 17.

<sup>406</sup> *ibid* para 50.

refused. In the case of misrepresentation they proposed that the insurer has to show that ‘(1) the business made a *misrepresentation*, 2) which *induced* the insurer to enter the contract, and 3) which a *reasonable person* in the circumstances would not have made.’<sup>407</sup>

Secondly, the duty of disclosure in consumer insurance. Following the Law Commission’s recommendations the Government published a Bill in December 2009 on the duty of a consumer in a consumer insurance policy, which received its First Reading in the House of Lords on 17 May 2011.<sup>408</sup> Clause 2 (2) of the Bill imposes a duty on a consumer ‘to take reasonable care not to make a misrepresentation to the insurer’, whilst clause 3 (1) provides that ‘Whether or not a consumer has taken reasonable care not to make a misrepresentation is to be determined in the light of all the relevant circumstances’. Consequently, the insured does not have to volunteer information. He only needs to answer questions asked by the insurer.

However, the first chapter of the thesis has already clarified that only the consumer insurance would be discussed in this thesis. Consequently the following analysis is based on consumer insurance only.

#### **4.5 Criticism of the Proposed Law for Consumer Insurance**

The proposed law shall significantly relax the insured in disclosing information at the time of taking a policy. The insurers can also ‘take steps to protect themselves by asking specific questions. It would seem that this should be an adequate safeguard to deal with situations which are considered to be unusual or out of the ordinary’.<sup>409</sup> Most respondents of the Consultation Paper also supported this approach as it is long established good practice and reflects the Financial Ombudsman Service’s (FOS) existing approach.<sup>410</sup>

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<sup>407</sup> *ibid* para 52.

<sup>408</sup> Consumer Insurance (Disclosure and Representations) HL Bill (2010-2012) 68. It has come into force as an Act being entitled ‘Consumer Insurance (Disclosure and Representations) Act 2012’ on 6 April 2013 without any change to the sections that are referred in this thesis. Since the original text was completed on 1<sup>st</sup> December 2011 the Bill is referred instead of the Act.

<sup>409</sup> Christopher Butcher, ‘Good faith in insurance law: a redundant concept?’ (2008) *Journal of Business Law* 375, 383. See also, B. Soyer ‘Reforming the assured’s pre-contractual duty of utmost good faith in insurance contracts for consumers: are the Law Commissions on the right track?’ (2008) 5 *Journal of Business Law* 385, 392.

<sup>410</sup> The Law Commission and The Scottish Law Commission *Reforming Insurance Contract Law - A Summary of Responses to Consultation* (May 2008) para 2.27

However, some of the respondents argued against abolishing the duty of volunteering information and said that the approach would lead to long and complex application forms.<sup>411</sup>

The Institute of Insurance Brokers said

We do not believe that it is practically possible for an insurer to ask every possible material question relating to a risk at the time of proposal. An attempt to do so would create proposal forms of enormous size and complexity – which would add substantial costs to the business process.<sup>412</sup>

Concurring with the minority view it is submitted that this law shall significantly reduce the duty of a consumer when entering into an insurance policy and create an imbalance from the other part. For the last couple of centuries insurance law has been criticised for heavily favouring the insurer, the law will be criticised for heavily favouring the insured if the proposed law comes into effect. According to this law the insured does not need to disclose any fact unless it is asked by the insurer. If the insured becomes aware that the insurer is relying upon a mistaken belief or fact, the insured shall have no duty to notify the insurer. The insured's duty not to misrepresent will only be effective when he discloses some information but he has no duty to volunteer information. Consequently, the insurer has to ask questions to obtain the information and it is unrealistic for the insurer to ask numerous questions to know every part of the insured's life. In Australia, the law requires the insurer to ask specific questions in eligible contracts. In a review of the Insurance Contracts Act 1984 life insurers opposed to apply such rule in life insurance contracts.<sup>413</sup> MLC stated that 'such an approach would place an unfair burden on life insurers and remove the general duty on the insured to disclose relevant matters the insured alone knows. Insurers cannot be expected to address all possible matters of relevance...not all possible questions can be included in the application'.<sup>414</sup> The questioning for general insurance policies would also be difficult. For example, an insured was threatened by her ex-boyfriend that her house would be on fire soon. Subsequently she decided to take a policy against fire risk and completed an insurance proposal form through online. In such case how could the insurer predict that someone

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<sup>411</sup> *ibid* paras 2.28 – 2.29.

<sup>412</sup> *ibid* para 2.28

<sup>413</sup> The Consumers' Federation of Australia, *Submissions on the Issues Paper* (Review of the Insurance Contract Act, 2004) <[http://icareview.treasury.gov.au/content/Reports/FinalReport/06\\_Chapter4.asp#P485\\_85087](http://icareview.treasury.gov.au/content/Reports/FinalReport/06_Chapter4.asp#P485_85087)> accessed 2<sup>nd</sup> November 2011; The life insurers like Brendan Pentony, The Legal Aid Commission of New South Wales, The Insurance Enquiries and Complaints Limited's Panel are also holding the similar view, published in the above report.

<sup>414</sup> See, MLC Ltd, *Panel Submissions on the Issues Paper* (Review of the Insurance Contracts Act, March 2004) para 4.12, <[http://icareview.treasury.gov.au/content/Reports/FinalReport/06\\_Chapter4.asp](http://icareview.treasury.gov.au/content/Reports/FinalReport/06_Chapter4.asp)> accessed 17 October 2011.

threatened her and ask questions accordingly?<sup>415</sup> Similarly, in *Lynch v Dunsford*,<sup>416</sup> a paper writing was stuck up at Lloyd's Coffee House on 22<sup>nd</sup> November 1808 stating that the vessel 'President' was 'deep and leaky'. Subsequently, when the policy was issued on that vessel, how could the insurer ask specific questions to the insured regarding this information whilst he had no knowledge about it? In the reasonable context it is expected that the insurer might have asked 'is your ship seaworthy'? If the insured had examined the ship three months before taking policy he would have answered positive. Whereas if this information was communicated to the insurer at the time of completing the form he would have wanted to know the current position. Lord Ellenborough C.J. therefore raised the question that 'with the knowledge of such a fact kept back from them [insurer], can they be said to have contracted upon equal terms?'<sup>417</sup> It is impossible to ask specific questions in today's insurance market where the majority policies are taken through the internet.<sup>418</sup>

Consequently, the insurers have to ask some general questions as they did in *Glicksman v Lancashire and General Assurance Co, Ltd*,<sup>419</sup> mentioned above, with the question 'have you ever been refused insurance before?' In this case the insured might have thought that if he took the word 'you' as singular his proposal for insurance either be refused or premiums be higher. Consequently, he answered in the negative, making the most of the ambiguous question. If the proposed law comes into effect the insured shall obtain some chance like this to hide some material facts causing unfair to the insurers. As such the scale will lean towards the insured from the side of the insurer and fail to create balance in these two parties.

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<sup>415</sup> See for instance, the questions asked by the insurance companies like Churchill <<https://uk2.churchill.com/insurance/home/PLB92183849566774939202/yourdetails.do;jsessionid=28308092ce103d1c704a>> or Direct Line <<https://uk2.directline.com/insurance/home/PLB92573849569674849202/yourdetails.do;jsessionid=28301ec788973e293067>> The questionnaires of these insurance companies clarify that they are not asking any question that would make an insured like Laura disclose the threat. Accessed to both sites on 17 April 2013.

<sup>416</sup> (1811)14 East 494; 104 ER 691.

<sup>417</sup> *ibid*, 497.

<sup>418</sup> Section 3(2)(c) of Consumer Insurance (Disclosure and Representations) HL Bill (2010-2012) 68 states that in determining the reasonable care of the insured the court has to consider how clear and specific question is asked by the insurer. See the questions asked by Churchill home insurer, Direct line home insurer following the above mentioned links.

<sup>419</sup> [1927] AC 139. See also, *Locker and Woolf v Western Australian Insurance Company* [1936] 1 K.B. 408; *Becker v Marshall* (1922) 11 Ll. L. Rep. 114; *Paxman v Union Assurance Society Ltd* (1923) 39 TLR 424; 15 Ll L Rep 206, 207 (McCardie, J); *Lee v British Law Insurance Co Ltd* [1972]2 Lloyd's Rep 49, 57; *Berger v Pollock* [1973]2 Lloyd's Rep. 442, 460 (Kerr, J.) where the existence of open cover could not relieve the plaintiff from avoidance; *Container Transport International Inc v Oceanus Mutual Underwriting Association (Bermuda) Ltd* [1984]1 Lloyd's Rep 476, 525 (Stephenson, LJ); *Cf Gate v Sun Alliance Insurance Ltd* [1995] LRLR 385, 399 (Fisher J.).

Furthermore, the proposed law has omitted the issue of materiality of the fact. As a result the insured has no duty to disclose it unless he is asked with specific question even if he knows that the fact would heavily affect the mind of the insurer. This contradicts the principal purpose of disclosure, which is to inform the insurer about the facts that are required to assess the risk. It is like a relation between a doctor and patient. When a patient visits the doctor, the doctor asks questions that he feels necessary and the patient's duty is to disclose as much information that he thinks may be important for the doctor to know as possible. If the patient does not inform the doctor of a fact because the doctor has not asked with a specific question when he knows that that fact would help the doctor to identify the disease, shall the law punish the doctor? Common sense suggests that the law shall blame the patient since he is the owner of the information and he is expected to communicate that information. It is not viable to get all the information by asking questions. Similarly in the insurance contract the insured is the owner of the information and it is not possible to get all the information by asking question.<sup>420</sup> Consequently, the proposed law will cause injustice to the insurer.

The proposed law shall cause further problems by leaving no scope for the insurers except asking very wide questions. For example, Sainsbury's Bank asked, 'Are you currently having any treatment for any medical or psychiatric condition, e.g. medicine, injections, diet, advice, or counselling etc., not already mentioned?'<sup>421</sup> The question is too wide to decide what to answer if the applicant is currently suffering from basic flu. It will be also confusing for a court to decide what the reasonably insured would answer in such case since the proposed law does not limit the duty to material facts. Further to that there is no option given to explain what sorts of medical treatment is being taken. If the insured answers 'yes' he will be taking an unnecessary risk of increased premiums, if he answers 'no', he will be lying and the insurer will have a good defence. The insured in *Godfrey v Britannic Assurance Co*,<sup>422</sup> took out a policy in 1961 when he was asked, have 'you suffered from any illness or accident or received medical advice or treatment with or without an operation?' In 1959 the insured

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<sup>420</sup> See Investment & Financial Services Association Limited *submission on the Issues Paper* (Review of the Insurance Contract Act, 19 April 2004) <[http://icareview.treasury.gov.au/content/Reports/FinalReport/06\\_Chapter4.asp#P485\\_85087](http://icareview.treasury.gov.au/content/Reports/FinalReport/06_Chapter4.asp#P485_85087)> accessed 2<sup>nd</sup> Nov 2011; Similar view was taken by Australian Life Underwriting and Claims Association, published in the above paper.

<sup>421</sup> The question is collected from an online application form for life policy created by the insurance company 'Sainsbury's bank' <[http://www.sainsburysbank.co.uk/insuring/ins\\_lifecover\\_life\\_skip.shtml?source=NETGOOGLLIFEEM010002&WT.srch=1&gclid=CMOO19X1i7gCFbMbtAodTIMAwQ](http://www.sainsburysbank.co.uk/insuring/ins_lifecover_life_skip.shtml?source=NETGOOGLLIFEEM010002&WT.srch=1&gclid=CMOO19X1i7gCFbMbtAodTIMAwQ)> accessed 2<sup>nd</sup> 2011.

<sup>422</sup> [1963]2 Lloyd's Rep 515.

underwent a hospital examination after losing weight and he was told that he might have minor kidney trouble and that he should take care. In May 1959 the insured again consulted his doctor and underwent a second examination. In this occasion he was informed that he had a mild chest infection which would clear up if he took the antibiotic tablets which were prescribed. In spite of these facts the insured answered ‘No’ and as such the court held in favour of the insurer. Hasson argued that ‘the phrase ‘medical advice or treatment’ in the above question should have been read as referring back to ‘illness or accident’ instead of being regarded as creating a new head of information. Reading the question in this way would have relieved the insured from being required to give the information he withheld’.<sup>423</sup> If the insured is relieved in such circumstances, as claimed by Hasson, then the issue becomes, how else can an insurer specify his question? Is it possible to make very clear and specific question in every case?

In the Consultation Paper the Law Commission proposed that the insurers should be allowed to ask general questions, but should not have any remedy in respect of an incomplete answer unless a reasonable consumer would understand that the question was asking about the particular information at issue.<sup>424</sup> They have provided<sup>425</sup> an example of this rule saying if ‘a proposal form asked about “any ailment or disease from which you suffer or have suffered”, a reasonable policyholder would understand that they should mention the recent diagnosis of cancer. However, they may not realise that they should mention an operation for an ingrowing toe-nail five years ago’. In such case, the Law Commission suggested, the insurers should be entitled to a remedy for the first omission, but not for the second.<sup>426</sup> Most respondents agreed with this approach. The FOS commented that ‘this reflects our existing approach, which itself reflects long-established good industry practice’.<sup>427</sup> However, fifteen respondents disagreed with this approach.<sup>428</sup> The author concurs with their view since the approach will confuse the insured what to answer when the said toe-nail operation in the example took place one year ago instead of five years ago.

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<sup>423</sup> R.A. Hasson ‘The Doctrine of Uberrima Fides in Insurance Law- A Critical Evaluation’ (1969) 32 MLR 615, 629.

<sup>424</sup> The Law Commission and The Scottish Law Commission *Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured* (Consultation Paper No 182, Discussion Paper No. 134, 2007) para 4.32

<sup>425</sup> The Law Commission and The Scottish Law Commission *Reforming Insurance Contract Law - A Summary of Responses to Consultation* (May 2008) para 2.32

<sup>426</sup> *ibid* para 2.32

<sup>427</sup> *ibid* para 2.33

<sup>428</sup> *ibid* para 2.34

A practical example of confusing the insured can be found in questions from home insurance applications used by some of the leading insurers in today's insurance market. Both Churchill and Direct Line ask the question, 'Tell us how many claims were made and/or losses suffered in the last 3 years by you and anyone living with you?'<sup>429</sup> In the explanatory note they said 'You must tell us about any claims or losses you, and any adult living with you has suffered in the last 3 years – whether insured or not.' Here, the lay insured may easily be confused with the terms 'any claims or losses' and 'whether insured or not'. He may get confused whether the term 'losses' includes the loss of small or unnecessary things such as a pen or paper, or the loss that has nothing to do with the policy that he is planning to take such as loss of his daughter's baby through abortion. The question of Gocompare.com is more vague as they ask whether 'anyone at the property ever had insurance declined, refused/cancelled or special terms imposed'.<sup>430</sup> Here they did not specify any time period. Consequently, it is submitted that the current 'good industry practice' as claimed by the FOS<sup>431</sup> is the practice of confusing the insured by asking vague questions. Making such vague questions was criticised by Lord Atkinson in *Glicksman v Lancashire and General Assurance Co, Ltd.*<sup>432</sup> Where the practice depends on the vague questions, this practice should not be used as a ground to abolish the volunteering information and only rely on the questions asked by the insurers. Moreover, under the current law the insured has option of not disclosing the unnecessary information. The Bill, on other hand, omits the requirement of materiality and requires the insured to take reasonable care not to misrepresent in answering the question meaning that the insured, when answering the aforementioned question, is in further confusion whether non-disclosure of small, unnecessary, embarrassing and family secret information would cause breach of reasonable care. Consequently, it is argued that if this proposed approach is eventually applied there is a very good possibility of changing the current minority view to the majority view in the near future.

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<sup>429</sup> See,

<<https://uk2.churchill.com/insurance/home/PLB92183849566774939202/yourdetails.do;jsessionid=28308092ce103d1c704a>> for questionnaires of Churchill home insurer and <<https://uk2.directline.com/insurance/home/PLB92573849569674849202/yourdetails.do;jsessionid=28301ec788973e293067>> for questionnaires of Direct line home insurer. Accessed to both sites on 17/04/2013.

<sup>430</sup> <<https://mygocompare.gocompare.com/SecuredPages/NewCustomer.aspx?product=3&cookieCheck=true>> accessed on 17/04/2013.

<sup>431</sup> The Law Commission and The Scottish Law Commission *Reforming Insurance Contract Law - A Summary of Responses to Consultation* (May 2008) para 2.33

<sup>432</sup> [1927] A.C. 139, 144. The case has been discussed above.



Moreover, Mance LJ in *Insurance Corporation of the Channel Islands v Royal Hotel*<sup>433</sup> said that ‘the human propensity is not to disclose embarrassing or prejudicial material fact’ and ‘there are the limited occasions on which matters of moral hazard come to light and the fact that they commonly do so only during investigation of a claim, tend to make moral hazard appear both rarer and more significant’. As such under this proposed law the insured shall obtain an opportunity to hide some material facts like moral hazard.

## 4.6 Approaches in Other Countries

### 4.6.1 Australia

Australia have imposed a duty on the insured to disclose every matter that is known to him being a matter that he ‘knows to be a matter relevant to the decision of the insurer whether to accept the risk and, if so, on what terms; or a reasonable person in the circumstances could be expected to know to be a matter so relevant’ (s. 21(a) & (b) of ICA). The insured is only required to disclose matters within his knowledge, but the knowledge of relevance to the insurer is a mixed objective/subjective test i.e. what the insured knows is relevant, or what a reasonable person in the circumstances could be expected to know is relevant to the prudent insurer.<sup>434</sup> Section 22 imposes the duty on the insurer to inform the insured of the general nature and effect of the duty of disclosure in writing before any contract is entered into. Section 21A allows the insurer to ask specific questions in eligible contracts that are relevant to the decision of the insurer whether to accept the risk and, if so, on what terms.<sup>435</sup> If the insurer fails to ask the questions it would be deemed that they have waived their right to disclosure.

The wording of section 21 is ambiguous, as it is unclear whether the phrase ‘a reasonable person in the circumstances’ is referring to the reasonable person in the insured’s position (including intrinsic factors) or in the extrinsic circumstances of the insured. Christopher Tay argues that due to the ambiguity remained in the section, the law failed to provide ‘fair and balanced approach to the duty of disclosure.’<sup>436</sup> In cases like *Lindsay v CIC Insurance*<sup>437</sup> and

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<sup>433</sup> [1998] Lloyd's Rep IR 151.

<sup>434</sup> Samuels J stated in *Mayne Nickless Ltd v Pegler* (1974) 1 NSWLR 228, 239: ‘In determining the question whether a particular fact is one which ought to be disclosed, the test to be applied is not what the assured thinks, nor even what the insurers think, but whether a prudent and experienced insurer would be influenced in his judgment if he knew of it.’

<sup>435</sup> ‘Eligible contracts of insurance’ are defined in regulation 2B of the *Insurance Contracts Regulations 1985*: as motor vehicle, home building, home contents, sickness and accident, consumer credit and travel insurances.

<sup>436</sup> Christopher Tay, ‘The duty of disclosure and materiality in insurance contracts – a true descendant of the duty of utmost good faith?’ (2002) 13 ILJ 1, 2.

*Twenty-first Maylux Pty Ltd v Mercentile Mutual Insurance (Aust) Ltd*,<sup>438</sup> the courts considered only extrinsic factors. Christopher Tay argued that consideration of extrinsic factors shall cause injustice to the insured since the ‘standard is likely to be too onerous ...[and] may penalise the honest and open insured for a lack of understanding of insurance law.’<sup>439</sup> The Australian Law Reform Commission originally proposed to apply the subjective test which would consider the intrinsic factor. Christopher Tay argued that ‘Fairness to all insureds could only be achieved by taking into account the individual differences in individual insureds,’<sup>440</sup> and as such recommended to apply the subjective test which shall ask what ‘a person in the circumstances of the insured could reasonably be expected to know to be a matter so relevant.’<sup>441</sup> Some courts however applied the subjective test in cases like *E E Delphin v Lumley General Insurance Ltd*.<sup>442</sup>

David Jenaway, on the other hand, argued that only extrinsic factors should be considered since ‘imposing intrinsic factors merely makes this test unjustifiably onerous for insurers’.<sup>443</sup> He pointed out that ‘most individuals who may fall short of the reasonable standard would only engage in insurance for ‘domestic’ products... disclosure in these contracts is actually guided by section 21A, which aims to enhance the position of the insured’. In these cases the insurer has the burden of asking clear and specific questions otherwise it would be deemed that they have waived their disclosure rights. ‘This transfers much of the onus from the insured to the insurer’.<sup>444</sup> Moreover, the insured shall get the protection of the duty of utmost good faith.<sup>445</sup> Considering these factors he suggested that ‘the reasonable person test in section 21 (1) should be confined to extrinsic factors only... [since] this construction presents the most commercial realistic alternative for insurers’.<sup>446</sup> There is another ground he added in favour of his argument that the consideration of intrinsic matters shall force ‘the court into a

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<sup>437</sup> (1989) 5 ANZ Ins Cas 60-913.

<sup>438</sup> (1989) 6 ANZ Ins Cas 60-954.

<sup>439</sup> Christopher Tay, ‘The duty of disclosure and materiality in insurance contracts – a true descendant of the duty of utmost good faith?’ (2002) 13 ILJ 1, 22.

<sup>440</sup> *ibid* 14.

<sup>441</sup> *ibid* 22.

<sup>442</sup> (1989) 5 ANZ Ins Cas 60-941.

<sup>443</sup> David Jenaway, ‘Section 21 of the Insurance Contracts Act 1984 – just who is this reasonable person?’ (2008)19 ILJ 69, 69.

<sup>444</sup> *ibid* 72.

<sup>445</sup> *ibid* 72.

<sup>446</sup> *ibid* 72-73.

time-consuming and subjective investigation...[whereas] the court is far better suited to an objective test based on extrinsic factors'.<sup>447</sup>

In order to resolve the problems related to section 21 and 21A necessary step was taken. There were several submissions made to the Treasury Review Panel that 'section 21 of the ICA puts an unreasonable burden on insureds in that they are expected to know what the insurer regards as relevant'.<sup>448</sup> Some stakeholders suggested that section 21 (1) should be replaced with a section 21A equivalent whereby the insurer would be required to ask specific questions and the insured must answer fully and honestly.<sup>449</sup> This approach was not supported by the insurers underwriting large commercial risks since asking a new insured with specific questions is not viable.<sup>450</sup> However, all agreed with the point that section 21A (4) (b), which allows the insurer to ask general 'catch all' type questions, should be repealed. Life insurers, on the other hand, opposed the application of section 21A in life insurance since 'it is impossible for them to think of and ask all relevant questions'.<sup>451</sup> Considering these responses the Treasury Review Panel opined that the mixed subjective/objective test laid down by section 21 should be retained but with some changes.<sup>452</sup> There proposals can be found in the, the Insurance Contracts Amendment Bill 2010,<sup>453</sup> which would repeal section 21 (1) (b) and replace with the following, that 'a reasonable person in the circumstances could be expected to know to be a matter so relevant, having regard to factors including, but not limited to, the nature and extent of the insurance cover to be provided under the relevant contract of insurance'. The Bill would also repeal section 21A (4) (b) and added section 21B whereby the insurer is also required to ask question at the time of renewal of contract.

#### 4.6.2 Malaysia

There are two Acts that are in operation in Malaysia. The Insurance Act 1996 applies to conventional insurance and the Takaful Act 1984 applies to Islamic insurance. The Insurance

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<sup>447</sup> *ibid* 73-74.

<sup>448</sup> See, Alan Cameron and Nancy Milne *Review of the Insurance Contracts Act 1984, Final Report on Second Stage: Provisions other than Section 54* (June 2004) para 4.15

<sup>449</sup> *ibid* para 4.8.

<sup>450</sup> *ibid* para 4.9.

<sup>451</sup> *ibid* para 4.14.

<sup>452</sup> *ibid* para 4.20. The changes have been suggested by Phillips Fox, see submission from Phillips Fox, dated 21 April 2004, page 3

<[http://icareview.treasury.gov.au/content/\\_download/exposure\\_draft\\_submissions/04\\_DLA\\_Phillips\\_Fox.pdf](http://icareview.treasury.gov.au/content/_download/exposure_draft_submissions/04_DLA_Phillips_Fox.pdf)> accessed 15 November 2011.

<sup>453</sup> The Bill passed the House of Representatives but did not pass through the Senate before it lapsed as a result of the federal election in August 2010. The Bill was reintroduced on 14 March 2013 at the House of Representatives and currently (as on 10/06/2013) in the second reading at Senate.

Act 1996 incorporated almost identical version of duty that is applicable in Australia. Section 150 says that

[A] proposer shall disclose to the licensed insurer a matter that - (a) he knows to be relevant to the decision of the licensed insurer on whether to accept the risk or not and the rates and terms to be applied; or (b) a reasonable person in the circumstances could be expected to know to be relevant.

The problems with the ‘reasonable person test’ identified in the Australian law also apply to Malaysian law. However, the Malaysian law has taken a slightly different approach in the case of questioning by the insurer. Section 150 (3) states that ‘where a proposer fails to answer or gives an incomplete or irrelevant answer to a question...and the matter was not pursued further by the licensed insurer, compliance with the duty of disclosure in respect of the matter shall be deemed to have been waived by the licensed insurer.’ The ICA does not require the insurer to make further inquiry if the insured fails to answer adequately since it is the duty of the insured to disclose, whereas the Insurance Act 1996 requires the insurer to make further inquiry giving further pressure on the insurer. The Takaful Act on the other hand does not say anything about the duty of the insured. This is the first Act in the world specifically addressing Islamic insurance policies. The Government may have intended to be familiarised with the problems and solutions with the application of Islamic policies before incorporating any duty on the insured. Consequently, any future amendment of the Act may incorporate the duties and remedies.

#### **4.7 Further Analysis and A Brand New Test**

In terms of disclosure, the author has compared the relationship between the insured and insurer with that of the patient and doctor. The patient needs to disclose the facts related to his disease upon which the doctor has to assess the nature of the disease. If the patient does not disclose an important factor or misrepresents, the doctor will not be able to provide the right treatment. In this case the law does not need to impose any obligation on the patient to disclose facts since every patient knows that he has to disclose everything otherwise he will be the ultimate sufferer. In insurance contracts the situation is different. If the insured does not disclose an important fact, the insurer will fail to assess the risk adequately, but it the insurer is the ultimate sufferer not the doctor. Since the ultimate sufferer is not the insured, the insured has plenty of opportunities to hide important facts causing the insurer losses. The law therefore has to impose the obligation of disclosure on the insured to save the insurer from such loss. Academics and courts have considered several policies to adequately impose

the obligation on the insured but each one has been criticised for being failure to establish fair balance between the interests of the insured and insurer. Some countries applied the policy of 'utmost good faith', which requires the insured to act considering the interests of the insurer in the contract and not to make any misrepresentation or hide any important facts. Some academics and courts commented that the rule of 'utmost good faith' is not necessary.<sup>454</sup> They suggest that a more specific duty can work more effectively. Some have suggested applying the concept of 'bad faith', as the U.S did, under which the insured shall be required not to act with bad faith.<sup>455</sup> The English law have applied the duty to act with 'utmost good faith' and also have emphasised the duty of disclosure by requiring that the insured has to disclose every material fact. The courts struggled for more than hundred years to determine how to decide the materiality of a fact. The question of materiality of fact caused a large problem making the Law Commission recommend a different approach. They recommend that the insured's duty is only to take reasonable care not to misrepresent leading the insurer asking the questions. The author has already analysed this approach and identified several problems that should occur upon its application. Australian law has applied the reasonable assured test for determining the materiality of a fact. There are two ways to apply the test and both of them are criticised for being failed to establish fair balance. The reasonable assured test was also recommended for England and Wales by The Law Reform Committee in 1957 but was rejected.

All academics and courts are striving to establish a fair balance between the interests of the insured and insurer. It is the insured who has got the information which has to be passed to the insurer so as to enable him to take the right decision. If the insured acts with a bad mind the insurer has no other method by which to ascertain the reality. Consequently, a duty is required to make the insured act with honesty. This may sound very straight forward, but the real problem occurs when the insured acts with honesty but still fails to disclose an important fact. This position can be compared with a hypothetical example where A has got a stock of apples and has made a contract with B that requires him to supply all the 'good quality apples'. When A has started choosing the apples he was unclear as to what constitutes a 'good quality apple'. Some apples have marks or black spots, and A thought they might not

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<sup>454</sup> See, *Mutual & Federal Insurance Co Ltd v Audtshoorn Municipality* (1985) 1 AD 419, 433; Christopher Butcher, 'Good faith in insurance law: a redundant concept?' (2008) JBL 375, 382.

<sup>455</sup> See, Douglas R. Richmond, 'Bad Insurance Bad Faith Law', (2003) 39 Tort Trial & Insurance Practice Law Journal 1; William, J. Perry and Heidi Nash-Smith '*Drake v Provident's* Effect on Insurers' Duty of Good Faith in English Law' (July 2005) 72(3) Defense Counsel Journal 298.

fall within the term 'good quality apples' so he did not supply them to B. B on the other hand considers that some of those apples are good quality apples and as such come under the term. Consequently, both A and B have got their own arguments to defend their position. If this example is applied in an insurance context A would be liable under the current law for breach of utmost good faith even if he acted with honesty. Hence, the law is unfair for him.

It would have been easier to deal with the situation had the contract required A to supply all the apples except the bad ones. In such case A would have been less confused over which apples not to supply as the term in this situation would emphasise the act of supply, meaning that he would be concentrated in supplying rather than the quality leading him to supply all the apples except the ones which were rotten. Consequently, B would not have had any objection since he had received the apples including the low quality ones. It would have been his duty to decide which one to use and which one to through away. It is a psychological factor that makes the difference. The same psychological factor can be considered in the case of disclosure by the insured. The author, therefore, recommends that *the insured has to disclose all the known facts except those which a reasonable person in the insured's position considers, with a degree of balance of probability, to be immaterial to disclose considering a reasonable insurer's interest in that fact in weighing up the risk. It is the duty of insurer to inform the insured about his duty of disclosure.*

#### **4.7.1 Justified for the Insurer**

Needless to say that the purpose of taking an insurance policy is for the insured to pass the risk of particular sufferings, that he may face following a peril, to an insurer by paying premiums. Before the risk is taken by the insurer he needs to know the nature of the risk. If the insured does not pass sufficiently detailed information the insurer will fail to assess the actual nature of the risk and as such will fail to take necessary protection either by imposing certain terms or increasing premiums or refusing to take the policy. If the law requires the insured to disclose material facts they will be confused about whether certain facts are material or not. Consequently he may not disclose some of the facts that a prudent insurer thinks important. For an insurer, this poses a risk of injustice, as he may not acquire all the necessary facts to accurately ascertain the risk. The law recommended by the author shall inspire the insured to disclose almost every fact unless it is immaterial. In this case, the insurer shall receive a good amount of information that may include some information that are immaterial in his view, but he will decide what he needs and what he does not need, in a

similar manner to B in the case of the supply of apples as mentioned above. Consequently, the insured should not have any objection regarding the disclosure of information leading to a fair duty in the view of an insurer.

#### 4.7.2 Justified For the Insured

It is now clear from the above analysis that the insured intends to take the policy because he is unable to secure himself against particular sufferings that he is afraid of. He wants to get support from the insurer if the suffering occurs like a patient wants to get support from a doctor as discussed earlier. In the latter case the patient discloses every fact to the doctor unless it is immaterial. Similarly an insured should also disclose every fact to the insurer unless it is immaterial for the insurer to know. Consequently, it is argued that the duty recommended by the author is logical and justifiable for the insured. The proposed law also requires the insurer to inform the insured about his duty as no insured can escape his liability defending his ignorance of the law. It is also good for the honest insured to be informed about the law beforehand.

#### 4.8 The Duty under Shariah Principles

It has been stated in chapter one that the thesis will analyse current English insurance law and the proposed law so as to find whether they are consistent with Shariah principles. Consequently, at this stage it is required to examine what the Shariah principles say about the pre-contract duty of an insured. The Islamic law strictly requires the disclosure of facts related to the product that may affect the judgment of the other party in the contract. Uqba bin Amir, a companion of Prophet (PBUH), said

وقال عقبة بن عامر – لا يحل لامرئ يبيع سلعة يعلم أن بها داء إلا أخبره

*'It is illegal for one to sell a thing if one knows that it has a defect, unless one informs the buyer of that defect'*.<sup>456</sup>

Prophet (PBUH) said,

عن عبيد بن رفاعة عن أبيه عن النبي صلى الله عليه وسلم قال التجار يحشرون يوم القيامة فجاء الإل من اتقى وبر وصدق

*Obaid bin Rafia from his father reported that Prophet Muhammad (PBUH) said, 'the merchants will be gathered on the Resurrection day as transgressors except those who were fearful of Allah, pious and truthful'*.<sup>457</sup>

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<sup>456</sup> Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari* (Dr. M Muhsin Khan tr) Kitab al-Buyu, Vol. III No. 291, pp. 165-166.

He also said

عن عبد الله بن الحارث رفعه إلى حكيم بن حزام رضى الله عنه قال قال رسول الله صلى الله عليه وسلم البيعان بالخيار ما لم يتفرقا أو قال حتى يتفرقا فإن صدقا وبينا بورك لهما فم يبيعهما وإن كتما وكذبا محقت بركة بيعهما<sup>458</sup>

*Narrated by Hakim bin Hizam, Allah's Apostle said, 'The seller and the buyer have the right to keep or return goods as long as they have not parted or till they part; and if both the parties spoke the truth and described the defects and qualities (of the goods), then they would be blessed in their transaction, and if they told lies or hid something, then the blessings of their transaction would be lost.'*<sup>459</sup>

One of the most respected Islamic scholars Abu'l-Husain 'Asakir-ud-Din Muslim stated in the introduction of 'Kitabul al-Buyu' of his famous book Sahih Muslim that:

A careful study of "Kitab al-Buyu" (the book pertaining to business transactions) will reveal the fact that the Holy Prophet (may peace be upon him) based business dealings strictly on truth and justice. He has strongly disapproved all transactions which involve any kind of injustice or hardship to the buyer or the seller. He wanted that both, the buyer and the seller, should be truly sympathetic and considerate towards each other. One should not take undue advantage of the simplicity or ignorance of the other. The seller should not think that he has unrestricted liberty to extort as much as possible from the buyer...<sup>460</sup>

It becomes apparent from these texts that an insured has to disclose all the defects and quality of the goods. It is also apparent from these texts that he is not bound to disclose information that are not considered as defect i.e. the things that are immaterial for the insurer to know. Hence, it is required to justify whether the current English law duty of volunteering material information is consistent with the Shariah principles or not. Following the terms used in the above mentioned texts and the current English insurance law one can argue, like Susan Dingwall, Shatha Ali and Ffin Griffiths<sup>461</sup>, that the current English law duty is consistent with

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<sup>457</sup> Maulana Fazlul Karim (tr), *Mishkatul Masabih*, Kitab al-Buyu, Book II. No. 6, p. 269.

<sup>458</sup> Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari* نصحا ولم يكتما ونصحا No. 1973

<sup>459</sup> Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari* (Dr. M Muhsin Khan tr) Vol-3, Book, 34, No. 293.

<sup>460</sup> Abdul Hamid Siddiqi (tr), *Sahih Muslim* (SH. Muhammad Ashraf, Kashmiri Bazar, Lahore, Pakistan 1973) Vol III, 792.

<sup>461</sup> Susan Dingwall, Shatha Ali and Ffin Griffiths, 'Regulatory approaches to *takaful*' in Sohail E. Jaffer (ed), '*Regulatory approaches to takaful*', *Islamic Insurance: Trends, Opportunities and the Future of Takaful* (Euromoney Books, London, 2007) 182. See also, 'Takaful insurance', Islamic insurance briefing (Norton Rose, November 2003) 2



the Shariah principles. The above analysis of English insurance law, however, has clarified that the current English law duty imposes an unfair and unreasonable burden on the insured. The imposition of such unfair and unreasonable burden on a party is not permitted by Shariah principles. As Abu'l-Husain 'Asakir-ud-Din Muslim stated 'He, the Prophet Muhammad (PBUH), has strongly disapproved all transactions which involve any kind of injustice or hardship to the buyer or the seller'.<sup>462</sup> Consequently, the pre-contract duty of an insured under current English insurance law contradicts Shariah principles.

It has been analysed above that the proposed duty under the Bill will also cause an unfair burden for the insurer. Consequently, this recommended duty also contradicts Shariah principles. This recommended duty will cause further contradiction by way of allowing the insured to conceal some defects that the insurer fails to ask about. Whereas, Shariah principles require a party to volunteer information that the other party would be interested to know. Hence, neither current English insurance law nor the law recommended in the Bill comes within the boundary of Shariah principles due to their unfair consequences. English insurance law could be brought within that boundary if the author's recommended duty is incorporated requiring the insured to disclose all facts unless it is immaterial in the eye of a reasonable insured considering the interest of a reasonable insurer about that fact. This duty will satisfy the Shariah principles since it does not allow the insured to conceal any defects as well as help the English insurance law reaching its target of establishing fair balance.

Until the recommended duty is applied in the English legal system the following term should be incorporated in the Islamic insurance contract so as to bind the insured to disclose all the defects: *in addition to the insured's statutory duty of disclosure of material fact the insured must disclose every fact except those that a reasonable insured in his position thinks unnecessary considering the interest of a reasonable insurer in that fact in weighing up the risk.*

The contract should also specify the remedy that should be available if the insured breaches this duty. The English law provides the insurer a choice of avoidance if he can satisfy both the materiality and inducement test. Consequently, the parties in the Islamic insurance contract can choose whether to avoid the contract or not. The author has suggested the

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<sup>462</sup> Abdul Hamid Siddiqi (tr), *Sahih Muslim* (SH. Muhammad Ashraf, Kashmiri Bazar, Lahore, Pakistan 1973) Vol III, 792.

possible remedies permitted by Islamic law in the next chapter.

## 4.9 Confusion around Some Specific Factors

There are two main factors that confuse a person and the courts when determining whether a fact should be disclosed or not. They are the role of rumours and moral hazard.

### 4.9.1 Rumour

The English courts held that the duty of disclosure is to be determined by reference to its immediate influence on the judgment of the underwriter at the time he accepts the risk and does not depend on what may subsequently be discovered. In *Seaman v Fonereau*<sup>463</sup> *Lynch v Hamilton*<sup>464</sup> *Lynch v Dunsford*<sup>465</sup> and *Brotherton & Ors v Aseguradora Colseguros SA & Anor*<sup>466</sup> the courts were of the opinion that if reports, rumours or allegations which were in circulation at the time the contract was made are material, they do not cease to be material on subsequently being shown to have been false. In *Lynch v Dunsford*<sup>467</sup>, discussed above, a piece of paper was stuck up on the wall at Lloyd's Coffee House on 22<sup>nd</sup> November 1808 stating the vessel 'President' was 'deep and leaky'. There was no indication as to who authorised or directed such an action. Anyone could fraudulently stick a piece of paper on the wall. Common sense suggests that such writing without proper authority cannot affect a business decision except pushing a sensitive person into further inquiry. The plaintiff's counsel logically argued that an insured 'cannot be obliged to communicate every idle rumour circulated upon'. If the insured was 'still bound to communicate it, he was made the instrument of increasing his own premium without any real cause.' Lord Ellenborough C.J. raised the question that 'With the knowledge of such a fact kept back from them, can they be said to have contracted upon equal terms?'<sup>468</sup> Bayley J stated that the insured should be liable 'not for not communicating the rumour, but for not communicating to the underwriters a fact material with reference to that rumour, which fact was within his knowledge, so as to enable them to apply it to the rumour, and exercise their judgment accordingly.'<sup>469</sup> The court accordingly rejected the argument in *Brotherton & Ors v Aseguradora Colseguros SA &*

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<sup>463</sup> (1743) 2 Stra 1183

<sup>464</sup> (1810) 3 Taunt 15

<sup>465</sup> (1811) 14 East 494

<sup>466</sup> [2003] 2 CLC 629

<sup>467</sup> (1811) 14 East 494; 104 ER 691.

<sup>468</sup> *ibid* 497

<sup>469</sup> *ibid* 498.

*Anor*<sup>470</sup> that the only circumstances requiring disclosure were those which actually existed, and that allegations or investigations with respect to possible misconduct did not have to be disclosed, if there was in fact no misconduct, even if there was at the time of placement no way of knowing or showing that.

In his notes to section 18 in *Digest of the Law relating to Marine Insurance* (1901) Sir Mackenzie Chalmers, the draftsman of the 1906 Act, stated, ‘an apparently well-founded rumour, though it turns out to be incorrect, must be disclosed’.<sup>471</sup> In *Brotherton & Ors v Aseguradora Colseguros SA & Anor*<sup>472</sup> Mance LJ stated:

[H]ad due disclosure been made, there would have been no call for any subsequent investigation or litigation about the correctness or otherwise of the intelligence. The insured has failed to make the disclosure he should have made. That carries with it the risk that underwriters would never learn of the intelligence at all, and never realise that there was anything to investigate.<sup>473</sup>

#### 4.9.1.1 Critical Analysis and Recommendation

English law has imposed the duty to disclose a rumour even if the insured knows it is false. In *Lynch v Dunsford*<sup>474</sup> Bayley J said<sup>475</sup> that the insured is not liable not for communicating the rumour ‘but for not communicating to the underwriters a fact material with reference to that rumour.’ In this case the insured was liable for not communicating the rumour even though the insured knew that the rumour was false. Sir Mackenzie Chalmers stated that an apparently well-founded rumour needs to be disclosed.<sup>476</sup> When a rumour can be said as ‘apparently well-founded’? In *Lynch v Dunsford*<sup>477</sup> there was no indication who authorised such information. Can it be said that the rumour was ‘apparently well-founded’ simply because someone wrote in a piece of paper and stuck it on a wall? If this is said to be an ‘apparently well-founded’ rumour then the law is certainly illogical because anyone who does not like the insured may write something on a piece of paper and stick it on a wall to cause the insured trouble. It is unjustifiable for the insured because he is required to disclose a rumour that he knows is false making him bound to raise his premiums without any good cause.

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<sup>470</sup> [2003] 2 CLC 629

<sup>471</sup> Sir Mackenzie Chalmers, *Digest of the Law relating to Marine Insurance* (6<sup>th</sup> edn, Arnould 1901) 574

<sup>472</sup> [2003] 2 CLC 629

<sup>473</sup> *ibid* [29].

<sup>474</sup> (1811)14 East 494; 104 ER 691.

<sup>475</sup> *ibid* 498.

<sup>476</sup> In his notes to s.18 in his *Digest of the Law relative to Marine Insurance* (6<sup>th</sup> edn, Arnould, 1901) 574. Cited by Mance LJ in *Brotherton & Ors v Aseguradora Colseguros SA & Anor* [2003] 2 CLC 629, 647.

<sup>477</sup> (1811)14 East 494; 104 ER 691.

According to the duty proposed by the Bill the insurer has to ask specific question to know about the rumour. It is evident from the questionnaires used by home insurers such as Churchill, Sainsbury's Bank, Privilege, Direct Line and Gocompare.com<sup>478</sup> that they do not ask any question that would require the insured to disclose any well-founded rumour. On the other hand, in some cases the well-founded rumour can be an important fact for the insurer to know about as recognised by academics<sup>479</sup>. Consequently, the insured will have a good chance to deprive the insurer from such important information.

The author's recommended duty should be able to establish the balance between the interests of the insured and insurer. The insured is the best person who knows whether there is a good chance for the rumour to be true or not. Consequently, if a reasonable insured considers that the rumour is something that is not immaterial for the insurer to know about then the insured has to disclose. Hence the insurer is learning about the rumour without asking any question and the insured is also not required to disclose any immaterial or ill-founded rumour.

#### **4.9.1.2 What Is the Approach of Shariah Principles?**

At this stage it is worth restating the following Hadith that was narrated by Uqbah ibn Amer

وقال عقبة بن عامر – لا يحل لامرئ يبيع سلعة يعلم أن بها داء إلا أخبره

*It is illegal for one to sell a thing if one knows that it has a defect, unless one informs the buyer of that defect.*<sup>480</sup>

This Hadith imposes the pre-contract duty of disclosure of defects of the product that is being sold. The above analysis has made it clear that some well-founded rumour can be treated as a defect. Consequently, disclosure of this type of rumour should be an obligation of the party under the Shariah principles. The nature of the duty of disclosure of the rumour under the current English insurance law, on the other hand, causes injustice to the insured as analysed above. The aforementioned and the following texts clarify that the Shariah principles do not allow any kind of injustice on any party to the contract.

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<sup>478</sup> The links of the questionnaires have been mentioned above.

<sup>479</sup> See for instance, Sir Mackenzie Chalmers, *Digest of the Law relating to Marine Insurance* (6<sup>th</sup> edn, Amould 1901) 574

<sup>480</sup> Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari* (Dr. M Muhsin Khan tr) Kitab al-Buyu, Vol. III No. 291, pp. 165-166.

Allah (SWT) says in Quran

وما الله يريد ظلماً للعالمين

*Allah means no injustice to any of His creatures.*<sup>481</sup>

He also says

وأقيموا الوزن بالقسط ولا تخسروا الميزان

*And establish weight in justice and do not make deficient the balance*<sup>482</sup>

Hence, it can be argued that this part of the current English insurance law contradicts with the Shariah principles. In these circumstances the duty recommended by the author for the English insurance law can be relied upon since that duty should establish a balance that both English insurance law and Shariah principles are looking for. Consequently, the Islamic policies can be applied under the English legal system without taking any special measure if the English law adopts the author's recommended duty. Until the English insurance law adopts that author's recommended duty the insurer of an Islamic insurance contract should withdraw his right to avoid the contract if the insured does not disclose the rumour that he knows is false or there is a strong possibility of being false by incorporating an adequate term. The term should state that *the insurer shall avoid the contract where the insured fails to disclose a rumour which a reasonable person in his position considers it, on balance of probability, to have the possibility to be true and also considers that it is not immaterial for a reasonable insurer to know in weighing up the risk. The insurer, however, shall not avoid the contract for non-disclosure of a rumour that does not come under this category.*

#### 4.9.2 Moral Hazard

In *Locker and Woolf Ltd v Western Australian Insurance Company Ltd*<sup>483</sup> Slessor LJ described moral hazard as 'a fact which if known to the company might lead them to take the view that the proposers were undesirable persons with whom to have contractual relations'.<sup>484</sup> He further added 'it was 'elementary' that it was one of the matters to be considered by an insurance company'. Lord Mustill stated in *Pan Atlantic*<sup>485</sup> that a moral hazard is a fact, which may merely increase the likelihood of it being made to appear (falsely) that loss or

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<sup>481</sup> *The Holy Quran*: 3:108.

<sup>482</sup> *ibid* 55:9.

<sup>483</sup> [1936] 1 K.B. 408.

<sup>484</sup> *ibid* 414 (Slessor LJ), Scott LJ and Eve J agreed at p. 415.

<sup>485</sup> [1995] 1 AC 501, 534, 538.

damage has occurred falling within the scope of the policy. In *Norwich Union Insurance v Meisels*<sup>486</sup> Tugendhat J stated that the ‘moral hazard to which underwriters are mainly looking is the tendency of some people who are insured and in financial difficulties to commit arson in order to make a fraudulent claim on insurers’.

In *Inversiones Manria SA v Sphere Drake Insurance Co plc (The 'Dora')*<sup>487</sup> Phillips J concluded on the evidence that (well-founded) pending charges of smuggling and the skipper's criminal record each created a material moral hazard. In *Gate v Sun Alliance Insurance Ltd*<sup>488</sup> Fisher J held that incidents of prior dishonesty by a proposer were capable of being material (in particular, as going to the risk of a false claim), whether or not they had been detected or had led to conviction. However, this is a wide area which covers several factors, such as dishonest activity that does not constitute a crime, criminal convictions for dishonest conduct and allegations of criminal offenses involving dishonesty.

#### **4.9.2.1 Dishonest Activity That Does Not Constitute a Crime**

In *Insurance Corporation of the Channel Islands v Royal Hotel*<sup>489</sup> Mr McHugh, a director and secretary of the defendant company, had prepared, in or about June 1991, false invoices in order to give the insured's bankers a more favourable impression of its profitability. He did not disclose this fact to the insurer at the time of renewing the policy in October 1991. The defendant argued that these invoices had been made for use in relation to the banks before renewal of the insurance if those become necessary or desirable, but those were not used eventually and therefore no criminal act had been established. Nonetheless the court concluded that this constituted moral hazard and was required to disclose. The court held that it is a question of ‘fact and degree and so of expert evidence’ to decide whether a particular ‘moral hazard’ is material to disclose or not. MacGillivray stated that the ‘dishonest conduct of the assured which demonstrates a real risk that the insurers will be asked to pay for fictitious or inflated losses is a material fact’.<sup>490</sup>

The above fact of the case can be compared with another fictitious fact where the insured deliberately did not disclose a material fact to his first insurer. The issue of non-disclosure

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<sup>486</sup> [2007]1 ALL ER (Comm) 1138 [23].

<sup>487</sup> [1989] 1 Lloyds Rep 69, 94-96. See also *James v CGU Ins. Co. Plc* [2002] Lloyd's Rep. I.R. 206, 224-228.

<sup>488</sup> [1995] LRLR 385 (High Court of New Zealand) 407

<sup>489</sup> [1998] Lloyd's Rep IR 151.

<sup>490</sup> Nicholas Legh-Jones QC, John Birds and David Owen (eds), *Macgillivray on Insurance Law* (11<sup>th</sup> edn, Sweet & Maxwell 2008) para 17-059.

did not come into question since no peril occurred. At the time of taking policy with the second insurer, the question is, is he required to disclose that dishonest act, i.e. not disclosing that material fact to the first insurer, to this new insurer? According to the above authority it can be inferred that the insured has to disclose that dishonest act.<sup>491</sup>

#### **4.9.2.1.1 Critical Analysis and Recommendation**

It is apparently logical to say that the insured has to disclose the dishonest act so that the insurer can accurately judge the proposer of the contract. In practice it is really hard to get such information from the insured when it is unknown to the public. Mance LJ in *Insurance Corporation of the Channel Islands v Royal Hotel*<sup>492</sup> said, as stated above, that ‘the human propensity is not to disclose embarrassing or prejudicial material fact’. The term ‘human propensity’ should mean that every reasonable person intends to hide such sorts of dishonest conduct. In *James v CGU*<sup>493</sup> Moore-Bick J said that ‘by their very nature many matters which insurers would regard as relevant to moral hazard are unlikely to be the subject of questions in a proposal form and, being often embarrassing as well as potentially prejudicial, are equally unlikely to be volunteered by the *potential insured*’.<sup>494</sup> Since the duty is based on the view of a reasonable person then, a question can be raised, why should the insured be liable for an act that a reasonable person does? Mance LJ also said that ‘there are the limited occasions on which matters of moral hazard come to light and the fact that they commonly do so only during investigation of a claim’.<sup>495</sup> This statement makes it clear that the usual practice is not to disclose dishonest conduct that does not constitute a crime. This leads to the question, if it is the usual practice then why should the insured be forced to do something unusual? If the Bill is passed and comes into effect as an Act the insured shall not be under any obligation to voluntarily disclose such sorts of dishonest conduct and it is not possible for the insurer to make specific question in this regard since he has no knowledge about it leading to non-disclosure of such conducts. The insured shall also not be required to disclose such conducts if the reasonable assured test is applied, since a reasonable person does not

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<sup>491</sup> *James v CGU* [2002] Lloyd’s Rep. I.R. 206 can also be referred in this context. In this case Mr. James failed to disclose several facts including the fact that he withheld money due in respect of National Insurance contributions and income tax deducted from his employees’ pay, he involved in disputes with the Customs & Excise over his VAT returns and with the Inland Revenue over the taxation of his business profits, he failed to perform his responsibility as a dealer in many cases. The issue of crime did not arise. The court held that the insurers were entitled to avoid the policy for non-disclosure of those dishonest conduct.

<sup>492</sup> [1998] Lloyd’s Rep IR 151.

<sup>493</sup> [2002] Lloyd’s Rep. I.R. 206.

<sup>494</sup> *ibid* [55] (emphasis added).

<sup>495</sup> *Insurance Corporation of the Channel Islands v Royal Hotel* [1998] Lloyd’s Rep IR 151.

disclose such fact as identified by above justices. Whereas the importance of disclosure of the non-criminal dishonest conduct cannot be ignored. In such circumstances a balance can be made by applying the duty recommended by the author. The duty shall require the insured to reasonably consider whether the conduct is immaterial for a reasonable insurer to know in weighing up the risk. If this duty is applied in the cases such as *Insurance Corporation of the Channel Islands v Royal Hotel*<sup>496</sup> the insured should not be liable for non-disclosure since, it is submitted that, such information would have been considered as immaterial by a reasonable insured who would have destroyed the papers which were never used and had no intention of using them in the future. Where the dishonest conduct occurred at some point in the past and the insured has never repeated any such act, a reasonable person will consider that act as immaterial for a reasonable insurer to know. On the other hand, the insured in the fictitious fact, that has been used above to compare the fact in *Insurance Corporation of the Channel Islands v Royal Hotel*,<sup>497</sup> would be required to disclose the dishonest conduct since that act was physically applied in the recent past and, it is assumed that, a reasonable insured would have considered it as material for a reasonable insurer to know. Hence, it can be argued that the duty recommended by the author will not impose any unfair burden on the insured in disclosing the dishonest conducts. Instead, it should impose a fair and reasonable burden on the insured in disclosing a dishonest conduct.

#### 4.9.2.1.2 Approach of Shariah Principles

Professor Ma'sum Billah commented<sup>498</sup> that only the present moral hazard is required to be disclosed under Islamic Law. He justified his view saying that Allah (SWT) tells people to do business harmoniously, encouraging them to find means of food in the world and also provides freedom of commercial activities for mankind. The writer mentioned following three verses of Qur'an in this regard,

أحل الله البيع وحرم الربا

'Allah (SWT) had permitted trade and forbidden usury'.<sup>499</sup>

<sup>496</sup> [1998] Lloyd's Rep IR 151.

<sup>497</sup> *ibid.*

<sup>498</sup> *Islamic and Modern Insurance Principles and Practices*, (Ilmiah Publishers, Malaysia, 2003) 208-209.

<sup>499</sup> *The Holy Quran*, 2:275.



فإذا قضية الصلاة فانتشروا في الأرض وابتغوا من فضل الله واذكروا الله كثيرا لعلكم تفلحون

*'And when the prayer is finished, then may you disperse through the land, and seek the bounty of Allah (SWT) (Through trade, business and undertaking lawful professions), and celebrate the promise of Allah (SWT) so that you may prosper'.<sup>500</sup>*

يا أيها الذين آمنوا لا تأكلوا أموالكم بينكم بالباطل إلا أن تكون تجارة عن تراض منكم

*'O you who believe, eat not up your property among your selves in vanities, but let there be amongst you traffic and trade by mutual good will'.<sup>501</sup>*

Following these verses he argued that if a person is required to disclose his past or future moral hazard then he shall be prevented from his freedom of commercial activity, whereas there is 'no Divine sanction preventing one because of his/her moral background from exercising the freedom of commercial activities'.<sup>502</sup>

The proposition held by Dr Ma'sum Billah is doubtful for following reasons. Firstly, it is not clear what he meant by present moral hazard. Every act that has just ended is considered as being in the past.<sup>503</sup> So the question becomes, the person who has committed an offence one hour before taking the policy should not he be required to disclose that moral hazard? Further, it is true that Islam allows freedom of commercial activity, but does this freedom extends to non-disclosure of defects? Certainly not. According to the Ahadith (plural of Hadith) mentioned above, a person is bound to disclose the defects of the goods before the transaction.<sup>504</sup> In insurance contracts a moral hazard of recent past is considered as a defect and as such must be disclosed under Shariah principles. Finally, 'moral hazard' is a wide term which includes a previous conviction for dishonest conduct. No Takaful participant will like to include a person in the Takaful pool who has recent criminal conviction for dishonest activity. It is therefore argued that the insured should be required to disclose moral hazard in

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<sup>500</sup> ibid 62:10.

<sup>501</sup> ibid 4:29.

<sup>502</sup> *Islamic and Modern Insurance Principles and Practices*, (Ilmiah Publishers, Malaysia, 2003) 208-209.

<sup>503</sup> See, A S Hornby, *Oxford Advanced Learner's Dictionary* (6<sup>th</sup> edn, Oxford University Press, 2000) 926.

<sup>504</sup> See also

عن واثلة بن الأسقع قال سمعت رسول الله صلى الله عليه وسلم يقول من باع عيبا لم ينبه لم يزل في مقت الله أولم تنزل الملائكة تلعنه

*Narrated by Waseleh b. Asqa'a (R.A): I heard the Holy Prophet (PBUH) say: whoever sells a defective thing without disclosing it continues to be in the wrath of Allah and angels continue to curse him. Maulana Fazlul Karim (trs), Mishkatul Masabih, Hadith No. 55, p. 284.*

the interest of the insurer and Takaful participants. However, certain non-criminal dishonest conduct should not be required to disclose since Prophet Muhammad (PBUH) said

عَنْ سَالِمِ بْنِ عَبْدِ اللَّهِ قَالَ سَمِعْتُ أَبَا هُرَيْرَةَ يَقُولُ سَمِعْتُ رَسُولَ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ يَقُولُ كُلُّ أُمَّتٍ مُعَافَى إِلَّا الْمُجَاهِرِينَ وَإِنَّ مِنَ الْمُجَاهِرَةِ أَنْ يَعْمَلَ الرَّجُلُ بِاللَّيْلِ عَمَلًا ثُمَّ يُصْبِحُ وَقَدْ سَتَرَهُ اللَّهُ عَلَيْهِ فَيَقُولُ يَا فُلَانُ عَمِلْتُ الْبَارِحَةَ كَذَا وَكَذَا وَقَدْ بَاتَ يَسْتُرُهُ رَبُّهُ وَيُصْبِحُ يَكْشِفُ سِتْرَ اللَّهِ عَنْهُ

*Narrated by Salim ibn Abdullah that he heard Abu Huraira (R.A) saying 'I heard Allah's Apostle saying. 'All the sins of my followers will be forgiven except those of the Mujahirin (those who commit a sin openly or disclose their sins to the people). An example of such disclosure is that a person commits a sin at night and though Allah screens it from the public, then he comes in the morning, and says, 'O so-and-so, I did such-and-such (evil) deed yesterday,' though he spent his night screened by his Lord (none knowing about his sin) and in the morning he removes Allah's screen from himself'.<sup>505</sup>*

Hazrat Umar (R.A) said:

حَدَّثَنَا الْحَكَمُ بْنُ نَافِعٍ أَخْبَرَنَا شُعَيْبٌ عَنِ الزُّهْرِيِّ قَالَ حَدَّثَنِي حُمَيْدُ بْنُ عَبْدِ الرَّحْمَنِ بْنِ عَوْفٍ أَنَّ عَبْدِ اللَّهِ بْنَ عُمَرَ قَالَ سَمِعْتُ عُمَرَ بْنَ الْخَطَّابِ رَضِيَ اللَّهُ عَنْهُ يَقُولُ إِنَّ أَنَسًا كَانُوا يُؤَخِّدُونَ بِالْوَحْيِ فِي عَهْدِ رَسُولِ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ وَإِنَّ الْوَحْيَ قَدْ انْقَطَعَ وَإِنَّمَا نَأْخُذُكُمْ الْآنَ بِمَا ظَهَرَ لَنَا مِنْ أَعْمَالِكُمْ فَمَنْ أَظْهَرَ لَنَا خَيْرًا أَمَّنًا وَقَرَّبَنَاهُ وَلَيْسَ إِلَيْنَا مِنْ سَرِيرَتِهِ شَيْءٌ اللَّهُ يُحَاسِبُهُ فِي سَرِيرَتِهِ وَمَنْ أَظْهَرَ لَنَا سُوءًا لَمْ نَأْمَنَّهُ وَلَمْ نُصَدِّقْهُ وَإِنْ قَالَ إِنَّ سَرِيرَتَهُ حَسَنَةٌ

*Umar bin Al Khattab said 'People were (sometimes) judged by the revealing of a Divine Inspiration during the lifetime of Allah's Apostle but now there is no longer any more (new revelations). Now we judge you by the deeds you practice publicly, so we will trust and favour the one who does good deeds in front of us, and we will not call him to account about what he is really doing in secret, for Allah will judge him for that; but we will not trust or believe the one who presents to us with an evil deed even if he claims that his intentions were good'.<sup>506</sup>*

According to the statement of 2<sup>nd</sup> Kaliph of Islam Umar (RA) the insured should not be required to disclose non-criminal dishonest conduct that has not been exercised in practice or

<sup>505</sup> Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari* ِباب سِتْرَ الْمُؤْمِنِ عَلَى نَفْسِهِ Hadith No. 5721; Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari* (Dr. M Muhsin Khan tr) Vol- 8, Book 73, No. 95.

<sup>506</sup> ibid *باب الشَّهَادَاتِ - كِتَابُ الشَّهَادَاتِ* Hadith No. 2498; Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari* (Dr. M Muhsin Khan tr) Vol- 3, Book- 48, No.-809

disclosed in public.<sup>507</sup> For example, the insured in *Insurance Corporation of the Channel Islands v Royal Hotel*<sup>508</sup> does not need to disclose his dishonest conduct of preparing false papers, whilst the insured in the, aforementioned, fictitious fact has to disclose his dishonest conduct of fraudulent non-disclosure in the first policy. The insured also does not need to disclose the dishonest conduct which is immaterial, e.g. an old dishonest conduct, since the Prophet Muhammad (PBUH) imposed the duty to disclose the defects that he knows, i.e. he thinks a particular fact is a defect that a reasonable insurer wants to know in weighing up the risk. In such circumstances a balance can be found in the recommendation made by the author for English legal system. If the law recommended by the author is applied in the English legal system, the Islamic insurance contracts can be applied without taking any further measure. However, since the current English insurance law imposes unjustifiable burden on the insured by requiring the disclosure of non-criminal dishonest conduct, Islamic insurance contracts should incorporate the following term so as to comply with both the English insurance law and Shariah principles. *The insurer shall not avoid the contract if the insured does not disclose a non-criminal dishonest conduct which has never been applied or disclosed to public. However, if that conduct is applied in practice or disclosed to public the insured has to disclose that fact to the insurer before entering into the contract, otherwise the insurer shall be allowed to avoid the contract.*

#### **4.9.2.2 Criminal Convictions for Dishonest Conduct**

Every criminal conviction does not constitute moral hazard. The conviction that involves dishonesty constitutes moral hazard. For example, speeding would not be moral hazard (although this might be a material fact when seeking motor insurance) since it does not involve dishonesty. However, the Rehabilitation of Offenders Act 1974 relieves the assured from disclosing spent offences. The conviction for mere dishonesty or old convictions are also not required to be disclosed. Waller LJ said in *North Star Shipping Ltd v Sphere Drake Insurance plc* ‘spent convictions no longer have to be disclosed, and old allegations of dishonesty or allegations of not very serious dishonesty, one would hope, expert underwriters would not suggest would influence the judgment of prudent underwriters’.<sup>509</sup> In *Reynolds v Phoenix* the Judge agreed with the insured’s expert that the fact that the assured had been convicted in 1961 of receiving two stolen tractor batteries worth £10-12, for which he was

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<sup>507</sup> The dishonest conduct that has not constituted a crime.

<sup>508</sup> [1998] Lloyd's Rep IR 151.

<sup>509</sup> [2006] 2 Lloyd's Rep 183, 189.

fined £250 was too trivial and too distant to be material (having happened 11 years before a policy against fire was taken out). The Judge rejected underwriters' expert evidence to the contrary.<sup>510</sup>

#### **4.9.2.2.1 Critical Analysis and Recommendation**

It is important for an insurer to know the honesty of the insured who he is going to make a contract with. Accordingly, the insurer should have the valid right to know about the criminal conviction for dishonest conduct since the dishonest conduct has been applied in practice and also the doer being punished by the courts, meaning that it is a serious factor for the insurer to consider. Consequently the current law is fair in this regard. The current law is also fair in relieving the insured from disclosing an old conviction (since the non-commission of offence for long period evidences his change in character) or a conviction for mere dishonesty. If the duty proposed in the Bill is applied the insurer has to ask question in order to know about the conviction. There are, however, insurers who do not ask question regarding the insured's conviction.<sup>511</sup> In such case the insured does not need to disclose his conviction under the proposed law of the Bill. On the other hand, the law recommended by the author shall require the insured to disclose every such conviction unless he reasonably considers that a particular conviction is immaterial for a reasonable insurer to know when weighing up the risk.

#### **4.9.2.2.2 Approach of Shariah Principles**

It is apparent from the statement of Umar (RA), as discussed above, that the dishonest conduct that is applied in practice and open to public is a defect that should be judged. Once the dishonesty is proved and the doer receives the punishment, the punishment itself becomes a proof of his dishonest mind which the insurer should have right to know for his and other Takaful participants' safety against that dishonest mind. However, if the doer of that dishonest conduct refrains from any further dishonest conduct for a long period he should not be required to disclose the conviction to the insurer since non-commission of any further dishonest conduct proves his change in character. Hence, both the current obligation of disclosure of criminal conviction for dishonest conduct and the non-requirement of disclosure of old conviction in the English legal system are Shariah compliant. The current English law

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<sup>510</sup> [1978] 2 Lloyd's Rep. 440

<sup>511</sup> See for instance, the questionnaires of Churchill home insurance <<https://uk2.churchill.com/insurance/home/PLB92183849566774939202/yourdetails.do;jsessionid=28308092ce103d1c704a>> also the questionnaires of Direct line home insurance <<https://uk2.directline.com/insurance/home/PLB92573849569674849202/yourdetails.do;jsessionid=2830a4496223242b7f4b>> accessed to both sites on 17/04/2013.

of non-requirement of conviction for mere dishonest conduct should also be Shariah compliant since the dishonesty is so trivial that it does not represent the actual character of the person. Consequently, there is no contradiction between the Islamic law and the current English law for this part of insurance practice. Under the author's recommended duty the insured shall be in a similar position to that of this part of the current English insurance law. However, if the law proposed in the Bill is applied the insurer shall be in trouble in learning about the convictions leading to unfair consequences for him. The law that causes unfairness should not be Shariah compliant.

#### 4.9.2.3 Allegations of Criminal Offences Involving Dishonesty

The English law requires the assured to disclose the allegation of criminal offence even if he is innocent and subsequently acquitted.<sup>512</sup> As May J said, obiter, in *March Cabaret v London Assurance* 'in any event [the insured] ought to have disclosed the fact of his arrest, charge and committal for trial at the date of renewal, even though in truth he was innocent'.<sup>513</sup>

Forbes J, on other hand, disagreed with this view in *Reynolds and another v Phoenix Assurance Co Ltd* and opined that the commission of the offence is material not the allegation.<sup>514</sup> His proposition has not been accepted in later cases due to some loopholes. For example, the person who is acquitted but actually committed can claim he did not commit it. In *The 'Dora'*<sup>515</sup> the court followed the earlier case *March Cabaret v London Assurance*<sup>516</sup> declining the view taken by Forbes J in *Reynolds and another v Phoenix Assurance Co Ltd*.<sup>517</sup> Phillips J held as obiter, that charges against an assured for smuggling which were made before the insurance was placed should have been disclosed whether or not the offences had actually been committed.<sup>518</sup> The reason for taking such view, Phillips J said, is that '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 as to the risk'. As such the judge upheld the principle of 'No smoke without fire'.<sup>519</sup>

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<sup>512</sup> May J, in *March Cabaret v London Assurance* [1975]1 Lloyd's Rep 169, 177

<sup>513</sup> [1975]1 Lloyd's Rep 169, 177

<sup>514</sup> [1978]2 Lloyd's Rep. 440, 460.

<sup>515</sup> [1989]1 Lloyd's Rep 69

<sup>516</sup> [1975]1 Lloyd's Rep 169,

<sup>517</sup> [1978]2 Lloyd's Rep. 440.

<sup>518</sup> *Inversiones Manria SA v Sphere Drake Insurance Co (The 'Dora')* [1989]1 Lloyd's Rep 69, 93

<sup>519</sup> *ibid* 93

In later case *The Grecia Express*,<sup>520</sup> Colman J followed the decision of *The 'Dora'*,<sup>521</sup> holding that allegations of criminality against a proposer, though known by the proposer to be groundless, but which were unresolved at the time of placing the risk, were material to be disclosed if there is evidence 'that the allegation would have influenced the judgment of a prudent insurer'.<sup>522</sup> The judge was not concerned in that case with the impropriety of the allegation but with circumstances that were said to raise doubts about the probity of the insured and thus relevant to moral hazard. He said that 'if the proposer had told the insurer of the allegation and also that it was unfounded, the insurer might well have preferred not to trust the word of the assured or might have preferred to conduct his investigation before agreeing to underwrite the risk'.

In *Brotherton v Aseguradora Colseguros SA (No. 2)* Moore-Bick J held that the 'foundation of the insured's duty of disclosure lies in an insistence that the insurer must be given a fair opportunity to assess the risk and a recognition of the fact that he is unlikely to have that opportunity'.<sup>523</sup> As such the allegation is material to disclose even if it is later unfounded against the insured. In the Court of Appeal, Mance LJ held that 'neither principle nor sound policy' supports the proposition that 'avoidance for non-disclosure of otherwise material information should depend upon the correctness of such information'.<sup>524</sup> He gave five reasons for holding such view:<sup>525</sup>

- 1) It is *prima facie* assumed that an insurer has been induced to take the policy by non-disclosure of matters within the assured's knowledge that would have influenced the prudent underwriter.
- 2) If the insured had disclosed the allegation it would have been for the insurer to decide whether they would take the risk or not and what would be the rate of the premium if they decided to take the risk. The assured would have nothing to do by later showing the incorrectness of the allegation.

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<sup>520</sup> *Strive Shipping Corporation and Another v Hellenic Mutual War Risks Association (The 'Grecia Express')* [2002]2 Lloyd's Rep 88, 131.

<sup>521</sup> [1989]1 Lloyd's Rep 69

<sup>522</sup> *Strive Shipping Corporation and Another v Hellenic Mutual War Risks Association (The 'Grecia Express')* [2002]2 Lloyd's Rep 88, 131.

<sup>523</sup> [2003] EWHC 335 (Comm) [26].

<sup>524</sup> [2003] 2 C.L.C. 629 [28], [29]

<sup>525</sup> *ibid* [29], [30].

3) It was argued that an insured carries the risk on himself that the underwriter would never find out the existence of allegation. But this, in itself, would be unfair to underwriter because that deprive him from proper analysis of risk and influence him to take the risk on false basis.

4) Had due disclosure been made by the insured, there would not have been any requirement of further investigation to verify the correctness of the allegation or litigation which would save the cost of shareholders of insurance company.

5) If no disclosure is made the insurer becomes bound to investigate the matter after discovering the intelligence. The matter then goes to litigation. 'A very substantial public enquiry or trial would probably be necessary to form any definite view as to the correctness of allegations like those reported in the Columbian media and the subject of the Columbian investigations'. All these cost effective steps are required due to pre-contractual non-disclosure of allegation.

Following these reasons Mance LJ concluded that 'it would be an unsound step to introduce into English law a principle of law which would enable an insured either not to disclose intelligence which a prudent insurer would regard as material or subsequently to resist avoidance by insisting on a trial'.<sup>526</sup>

The following example shall clarify the effect of the law. An insured took a motor insurance policy in January 2006. He caused an accident in August 2006. He made a claim under the usual process, but the insurance company discovered that there was an allegation against the insured of stealing diamond in December 2005. The insured did not declare this since he knew that he was innocent and eventually he was found not guilty in May 2006. The insurer would still be able to avoid the contract if he can prove that the fact was material at the time of taking policy and he would not have taken the policy or would have taken it in different terms had he known the fact at that period.<sup>527</sup> If the insurer is so allowed the insured would be left in serious bad position psychologically and economically for a reason where he was fully innocent. If he had disclosed the allegation he would have been bound to pay extra premium

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<sup>526</sup> *ibid* [31].

<sup>527</sup> In such case *Drake Insurance v Provident Insurance plc* [2003] EWCA Civ 1834, [2004] Lloyd's Rep I.R 277 will not be applied since he has satisfied the inducement test. The decision of this case will be discussed in the next chapter.

for an allegation which was baseless. In both ways the insured suffers greatly. Further to that, the third party would also be in trouble of recovering money from the insurer.

However, the court in *Drake Insurance v Provident Insurance*<sup>528</sup> attempted to ease the situation by holding that the insurer's state of mind is not as important but the true facts at the time of the contract. The true fact is that the insured was not guilty. Consequently, the insurer should not be allowed to avoid the contract. However, the court in the later case *North Star Shipping v Sphere Drake Insurance*<sup>529</sup> did not consider this approach. Waller LJ rather said 'Drake may provide an answer in some but very few cases, and in any event does not seem to provide a remedy for the increased premium that an insured may have had to pay on the basis of a false allegation'.<sup>530</sup> In this case the issue for the court was 'what is the correct approach to an allegation of dishonesty which at the time of placement the insured would maintain was false, and ultimately after placement of the insurance turns out to be false, or an allegation that the insurers do not seek to establish as true'.<sup>531</sup> The current law that has been recognised by the court to solve this issue is 'the obligation to disclose a false allegation of serious dishonesty' though Waller LJ considered this to be injustice.<sup>532</sup> He stated,

The law in this area is... capable of producing serious injustice. If every false allegation of dishonesty must be disclosed in all types of insurance, that may place some insureds in the position of finding it difficult to obtain cover at all, and will certainly expose them to having the rates of premium increased unfairly. I do not myself see it as a practical answer to say that exculpatory material can be produced, ...In many instances he would be likely to take the view there is no smoke without fire and turn the placement down or at the very least rate the policy to take account of the allegation.<sup>533</sup>

This is certainly unfair for the insured and as such Rix LJ stated that 'the whole English commercial law has not favoured the process of balancing rights and wrongs under a species of what would now be called a doctrine of proportionality'.<sup>534</sup>

Tugendhat J drew a balance between the judgment of Mance LJ and Waller LJ holding that both applied the test of materiality by reference to what would influence the judgment of a prudent insurer. The materiality of an allegation depends on the circumstances. He held:

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<sup>528</sup> [2004] Q.B. 601 [66] (Rix LJ)

<sup>529</sup> [2006] 2 Lloyd's Rep. 183

<sup>530</sup> *ibid* [17].

<sup>531</sup> *ibid* [3].

<sup>532</sup> *ibid* [20].

<sup>533</sup> *ibid* [17].

<sup>534</sup> *Drake Insurance v Provident Insurance* [2004] Q.B. 601, [88].



There was room for a test of proportionality, having regard to the nature of the risk and the moral hazard under consideration. There may be things which are too old, or insufficiently serious to require disclosure, whether or not there is exculpatory material. And in cases where the information would be material and disclosable if there were no exculpatory material, the degree of conviction that the exculpatory material must carry, must depend on all the circumstances known to the insured.<sup>535</sup>

#### **4.9.2.3.1 Critical Analysis and Recommendation**

It is apparent from the above analysis that both the insured and insurer have got arguments in their favour. Tugendhat J simply attempted to bring a balance by raising the issue of consideration of surrounding circumstances in determining the materiality. Whereas the current test of materiality is itself unreasonable and fails to establish fair balance as analysed above. The proposed change in duty made by the Bill shall make it complicated for the insurer to know about the allegations by merely asking questions. Further to that the insured has to take only reasonable care not to misrepresent. Where the insured claims that he is innocent his duty to take reasonable care should not be breached if he does not disclose the allegation even if he is subsequently found guilty. Consequently, the proposed law shall substantially favour the insured causing unfair consequence for the insurer. The duty recommended by the author shall require the insured to reasonably consider on the balance of probability whether the allegation is immaterial for a reasonable insurer to know or not. Consequently, the insured who claims to be innocent but finds that a reasonable person in his position would doubt his innocence must disclose the allegation to the insurer since it is not an immaterial information for a reasonable insurer. On the other hand, if a reasonable person, following necessary evidences, considers him innocent against the alleged allegation the insured should not be required to disclose since the information would be considered as immaterial for a reasonable insurer. Accordingly, a fair and logical obligation will be imposed through the proposed duty.

#### **4.9.2.3.2 Approach of Shariah Principles**

It has been stated above that Islamic law requires the defects of the subject to be disclosed. Defect means those defects that affect the quality of the subject matter and are taken into account by the purchaser. Here the question is whether the allegation of criminal dishonest conduct is a defect of the insured. Since the allegation is something that the insurers take into

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<sup>535</sup> *Norwich Union Insurance Limited v M.Meise* [2007] 1 All ER (Comm) 1138 [25].

consideration in the normal course of business, this should be treated as a defect and as such must be disclosed. However, it would be unfair for the insured to be required to disclose a clearly baseless allegation as analysed above. Imposition of unfair burden is also prohibited in Islam, whereas the current English insurance law imposes this unfair burden on the insured. Consequently, this part of current English insurance law contradicts with Shariah principles. The law proposed in the Bill will also fail to establish fair balance as analysed above. It has been argued that the fair balance should be established with the author's recommended duty. Hence, the English insurance law would be able to achieve its target by imposing the author's recommended duty and by such imposition it would be able to accommodate Shariah principles too. Since the current English insurance law contradicts with Shariah principles the Islamic insurers should incorporate the aforementioned term recommended by the author until the English law adopts the author's recommended duty.

## **B) Duty of the Insurer**

### **4.10 Duty of Disclosure by the Insurer**

Section 17 of Marine Insurance Act imposes the duty of utmost good faith on the insurer but does not impose any specific duty of disclosure. Some courts, however, stated that the insurer has to disclose before making a contract the facts that may affect the insured's rights in the contract following the duty of utmost good faith. Lord Mansfield in *Carter v Boehm*<sup>536</sup> described the duty by giving an example that the insurer must disclose the fact that he is aware that the ship on which insurance is proposed has already arrived.<sup>537</sup> The ship that has already arrived does not carry the risk that has been proposed to insure. Where there is no risk there is no insurable interest and where there is no insurable interest there cannot be a valid insurance contract. Where there is no valid insurance contract there is no question of duty of good faith. As such, it is submitted with respect, the example given by Lord Mansfield is not accurate.<sup>538</sup>

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<sup>536</sup> (1766) 97 E.R. 1162.

<sup>537</sup> *Carter v Boehm* (1766) 97 E.R. 1162, 1164. See also Andre Naidoo 'Post-Contractual Good Faith - A Further Change in Judicial Attitude' (2005) 68(3) MLR 464, 465.

<sup>538</sup> The similar example has been given by Lord Jauncey in *Banque Financiere de la cite v Westgate Insurance co Ltd (sub nom Banque Keyser Ullman SA v Skandia (UK) Insurance Co Ltd)* [1990]2 All ER 947, 960 that the insurer insures against fire a house which he knows has already been demolished. This example is also, with respect, invalid due to the same reason.

In *Banque Financiere de la Cite v Westgate Insurance Co Ltd*<sup>539</sup> Steyn J stated that ‘[The duty] must have some utility beyond the example given by Lord Mansfield’.<sup>540</sup> He said that the duty should cover ‘matters peculiarly within the knowledge of the insurers, which the insurers know that the insured is ignorant of and unable to discover but which are material in the sense of being calculated to influence the decision of the insured to conclude the contract of insurance’.<sup>541</sup> He laid down a test to identify the duty, namely ‘by asking the simple question: did good faith and fair dealing require a disclosure?’<sup>542</sup> The Court of Appeal considered this test as too wide and uncertain and added this gloss,

...The duty falling on the insurer must at least extend to disclosing all facts known to him which are material either to the nature of the risk sought to be covered or the recoverability of a claim under the policy which a prudent insured would take into account in deciding whether or not to place the risk for which he seeks cover with that insurer.<sup>543</sup>

The House of Lords approved this definition of materiality and held that the test of materiality should mirror the test of materiality as applied to the assured at placing, namely whether the fact which should be disclosed would influence the judgment of a prudent assured in deciding whether to enter into the insurance contract on the particular terms proposed, including that of premium.<sup>544</sup>

#### **4.10.1 Critical Analysis and Recommendation**

The duty of an insurer that the courts have recognised is the duty of a buyer of risk. Whereas the insurance contract is also a contract of security, where the insured buys the security in return of premiums from the insurer against the difficulty that he may face if peril occurs. Since the courts and law makers consider the insurance policy as only a buying and selling of risk they are very cautious in providing sufficient protection to the insurer against the insured so as to make sure that the latter, as a seller of risk, does not cause any trouble to the former, the buyer of the risk, by hiding any material information. The law, on the other hand is

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<sup>539</sup> [1987] 2 W.L.R. 1300.

<sup>540</sup> *ibid* 1330.

<sup>541</sup> *ibid* 1330.

<sup>542</sup> *ibid* 1330.

<sup>543</sup> [1990]1 QB 665, 772 (Steyn J).

<sup>544</sup> [1991]2 AC 249, [1990] 3 WLR 364..

almost careless about the right of the insured,<sup>545</sup> as a buyer of security, against the insurer, as a seller of security. Whereas the insured as a buyer of security should have the similar right to that of the insurer in the previous case. It is the right of an insured to know whether he is going enter into a contract with a company who is capable to provide sufficient protection if peril occurs. As a buyer of security, the insured has a right to know whether the directors of the insurance company have got any criminal records, as an insurer has such right against the insured as a buyer of risk.<sup>546</sup> The insured has right to know the strength of insurer's financial status, number of claims accepted and refused in each year, how many years of experience they have in running this business.

The critics may argue that the regulatory authority is responsible to ensure that the insurers are sufficiently financially solvent to provide the security that they are selling. For example, solvency margin as applied by The Insurance Companies Regulation 1994. The Individual Capital Adequacy Standards (ICAS) regime has applied from 31 December 2004. Under this framework, firms are required to undertake regular assessments of the amount and quality of capital that is adequate for the size and nature of the business. Solvency II<sup>547</sup> requirement is to be applied from 1<sup>st</sup> January 2014.<sup>548</sup> Following these measures the insurance companies such as Drake Insurance plc have been stopped by FSA from underwriting new policies in 2000 due to their failure to maintain the required margin of assets over its liabilities.<sup>549</sup> Salaam Halal has closed to new business for failing to secure the required capital set by the regulatory authority.<sup>550</sup> Consequently, the financial status of the insurer should not be a material fact for the insured to know. The critics may also argue that the regulatory body also

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<sup>545</sup> The Law Commission said in *Damages for Late Payment and the Insurer's Duty of Good Faith* (Issues Paper 6, 2010) para S.33, 'the law on the insured's duties is much more developed than the law on the insurer's duties'. At para 4.22 they said 'The case law on the insurer's obligations is relatively undeveloped.'

<sup>546</sup> See, *Locker and Woolf Ltd v Western Australian Insurance Co Ltd* [1936] 1 KB 408, 414 ( Slessor LJ); *Galle Gowns Ltd v Licenses and General Insurance Co Ltd* (1933) 47 Ll. L. Rep. 186; *O. and R. Jewellers Ltd v Terry and Jardine Insurance Brokers Ltd* [1999] Lloyd's Rep. I.R. 436; *Roselodge Ltd v Castle* [1966] 2 Lloyd's Rep. 113.

<sup>547</sup> Solvency II has three main pillars: Pillar 1: consists of the quantitative requirements (for example, the amount of capital an insurer should hold); Pillar 2: sets out requirements for the governance and risk management of insurers, as well as for the effective supervision of insurers; Pillar 3: focuses on disclosure and transparency requirements.

<sup>548</sup> Directive 2012/23/EU.

<sup>549</sup> Drake Insurance Plc went into liquidation for being failed to maintain the required margin of assets over its liabilities. See, FSA/PN/057/2000 released on 09/05/2000

<<http://www.fsa.gov.uk/Pages/Library/Communication/PR/2000/057.shtml>> accessed 5 Feb 2010; FSA/PN/060/2000 released on 12/05/2000

<<http://www.fsa.gov.uk/Pages/Library/Communication/PR/2000/060.shtml>> accessed 5/02/2010.

<sup>550</sup> Jamie Dunkley, 'Islamic insurance company Salaam Halal closes to new business' *The Telegraph* (18 Nov 2009) <<http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/6600525/Islamic-insurance-company-Salaam-Halal-closes-to-new-business.html#>>

ensures that the directors are fit for the purpose. For example, FSA has fined and banned three directors of Black and White Group Ltd for numerous failings in relation to the sale of mortgages and payment protection insurance.<sup>551</sup> Consequently, the profile of a director should not be material fact for the insured to know.

It is submitted in reply to these points that the disclosure of this information is not required to satisfy the insured's need to ascertain the financial stability of the company and suitability of its directors. The information is not required for an insured to judge the competency of a company in the market. The information is material because of the insured's need to finding the right insurance company for the security that they are looking for. It is obvious that every company in the market is competent since they have fulfilled the obligations imposed by the regulatory authority. Their level of competency, however, is different in the eye of a consumer. Hence, the published information will allow them to choose the better insurance company that they are looking for. Moreover, the publication of financial statements is already in practice by the companies like bank in the UK. The banks do not publish their financial statements to prove their competency to their shareholders. Their publication of these statements simply helps a shareholder to decide whether to be part of this company or not. Similarly the Islamic insurance companies in Malaysia publish financial statements on their website which making it easy for an insured to choose the right insurer for him.<sup>552</sup> Whereas an insured in the UK remains absolutely in blank regarding the insurance company upon which he rests the security of his life or property.<sup>553</sup> The moral hazard of a director should also be disclosed for similar reason. This information should be disclosed on the website instead of communicating to the person approaching for a policy, so as to make it easier to choose the right insurer for anyone looking for a policy. Such approach will establish the transparency of the company. The higher the transparency the stronger confidence will be grown in the insurance market.

Academics have also taken the view that the insurer has to disclose the material information but failed to identify what makes a fact material in this case.<sup>554</sup> It is apparent from the above analysis that the material facts are those facts that affect the decision of an insured in

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<sup>551</sup> 'Directors of Black and White Group Limited fined and banned for widespread mortgage and PPI failings' (12 December 2012) FSA/PN/112/2012

<sup>552</sup> See for instance, <[http://www.takaful-ikhlas.com.my/downloads/growth\\_fund.asp](http://www.takaful-ikhlas.com.my/downloads/growth_fund.asp)> accessed on 17/04/2013

<sup>553</sup> See for instance, <<http://www.directline.com/home-insurance/>> accessed on 17/04/2013.

<sup>554</sup> See, A Naidoo and D Oughton, 'The confused post-formation duty of good faith in insurance law: from refinement to fragmentation to elimination?' (2005) *Journal of Business Law* 346, 358-359.

choosing the right insurance company. However, if the insurer is required to disclose only the material facts he may struggle to decide which facts could be material as analysed above. The author therefore recommends that *an insurer has to disclose all the known facts except those which a reasonable person in his position considers, on balance of probability, to be immaterial to disclose considering a reasonable insured's interest in that fact in choosing an insurance company.*

#### **4.10.2 Approach of Shariah Principles**

The aforementioned analysis has already clarified that the Shariah principles emphasise on the disclosure of every defect that may affect the mind of the buyer in assessing the value of the product. Imam Muslim stated that the duty of disclosure is for both parties in the contract. He said, 'all transactions should be based on the fundamental principle of "Ta'auanu ala birri wa't-taqwa" (mutual co-operation for the cause of goodness or piety).<sup>555</sup> A transaction not based upon this sound principle is not lawful.' He further said

Islam tries to be fair to both parties to a transaction. Any step on the part of one, that is advantageous to him and disadvantageous to the other, is not permissible. The seller is expected to make the defects (if any) in the goods manifest to the buyer, nor is the buyer expected to take undue advantage of the ignorance of the seller.<sup>556</sup>

In an Islamic policy the Takaful participant pays the premiums to the risk pool to share the risk with other participants. It is important for a participant to know whether the other participants are honest or not, whether the insurer is well adequate in handling the risk pool or not, whether the directors of the insurance company have got any previous convictions. With all the information at hand the participant can choose the right insurance company for him. Accordingly, these facts can be seen as defect which an insured shall rely on in taking the decision whether he should take a contract with particular insurer or not. It is, therefore, the duty of an insurer to disclose all the information unless it is immaterial for a Takaful participant in choosing the right insurance company for him. If the law recommended by the author is applied in the English legal system an Islamic insurer shall not be required to take special measure since that will comply with the Shariah principles. However, an Islamic insurance contract made under current English legal system should include the following term so as to comply with Shariah principles. *In addition to the Statutory duty of utmost good*

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<sup>555</sup> Abdul Hamid Siddiqi (tr), *Sahih Muslim* (SH. Muhammad Ashraf, Kashmiri Bazar, Lahore, Pakistan 1973) Vol III, 792.

<sup>556</sup> *ibid* 795.

*faith the insurer shall disclose all the known facts except those which a reasonable person in his position considers, on balance of probability, to be immaterial to disclose considering a reasonable insured's interest in that fact in choosing an insurance company.*

#### **4.11 Conclusion**

Current English insurance law has imposed the duty of utmost good faith for both the insured and insurer but mainly applied on the insured by way of imposing the duty of disclosure. Legislatures and the courts have found that the insured possesses the information about the object that is insured and as such he has the principal duty of disclosure. The courts have also found that the human nature is to hide embarrassing information and as such widened the duty in such way that the insured does not get any option to avoid the disclosure. Whilst the duty is imposed to cause fairness between the parties, its actual effect causes serious unfairness. It is so wide that the insured has to disclose the allegation that he knows is false causing him to have an increased premiums. It cannot be justified that the innocent insured faces the same remedy to that of the fraudulent insured. It is nonsense since it requires the lay insured to read the mind of a prudent insurer in determining the materiality of the fact. These loopholes have made the current English insurance law contradictory with Shariah principles.

Whereas, both the English insurance law and Shariah principles intend to impose the duty of disclosure, if the loopholes are removed from the English insurance law there should not be any contradiction in this part of the law. The Bill on disclosure in consumer insurance has proposed to impose the duty on the insured to take reasonable care not to misrepresent. The duty does not require any voluntary disclosure causing the insurer to ask questions. Where the questions are not clear and specific the insured shall not be liable for wrong answer as long as he acts reasonably. In such case the insurer shall be in trouble asking clear and specific question since they do not prepare the questionnaires for certain insureds. The majority policies are now taken through the internet and as such they prepare widely framed questionnaires for everyone.<sup>557</sup> Further to that they do not know the kinds of moral hazard or allegation that a particular insured has got so as to ask him specific questions in that regard. If the insurer is obliged, under the proposed law, to get information only through questionnaires then he will be in unfair situation where the insured hides some important information simply because no specific question was asked. Such unfair duty should not be Shariah compliant.

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<sup>557</sup> See, B. Soyer, 'Reforming the assured's pre-contractual duty of utmost good faith in insurance contracts for consumers: are the Law Commissions on the right track?' [2008] JBL 385, 392.

The author recommends that the insured should be required to disclose every fact unless it is immaterial in the eye of a reasonable insured in his position considering the interest of a prudent insurer. The author claims that the duty is fair for both parties and supported his argument with different examples. Since the duty is fair for both parties the English insurance law should be capable to accommodate Islamic policies if this duty is adopted. However, until English law incorporates the recommended duty the Islamic insurers should incorporate the author's recommended terms in the contract so as to give effect to the recommended duty.

Whilst legislatures, courts and academics are highly concerned about the duty of the insured, the other party of the contract i.e. the insurer does not owe a mentionable duty. Consequently, it is disproportionate for the insured. Such disproportion is caused due to the absence of his defined duty. Whereas he has the duty as a seller of security to disclose the facts that should help the insured in choosing the right insurer who he thinks can provide better security once peril occurs. The author therefore recommends a defined duty for an insurer which should be imposed in English legal system. If it is so imposed the Islamic policies can be accommodated in that legal system without taking any special measure, otherwise the term recommended by the author should be incorporated in the contract.



## Chapter 5 – Remedy for Breach of Pre-Contract Duty

### 5.0 Introduction

Chapter Four has demonstrated that section 17 of the Marine Insurance Act 1906 imposes a duty of disclosure on both the insured and insurer. If either party breaches that duty the section allows the innocent party to avoid the contract *ab initio*. Section 18 of the Act imposes a duty on the insured to disclose every material fact before making the contract. If he fails to disclose any material fact the section allows the insurer to avoid the contract. The remedy for breach of these duties by the insured is viewed by the courts as being harsh and unreasonable.<sup>558</sup> The remedy for breach of the insurer's duty to maintain utmost good faith has also been argued to be unworkable since the remedy favours the insurer instead.<sup>559</sup> Consequently, the remedy provided under these sections is claimed to be disproportionate, unjustifiable and unreasonable. R.A. Hasson, therefore, commented that 'the current English principle is thoroughly unsatisfactory, in that it does not reflect the "reasonable expectations" of insurer and insured and in that it is a rule that works against "fairness" in the insurance contract'.<sup>560</sup> By contrast, Shariah principles prohibit any kind of unfairness, which leads to contradiction with English insurance law. The Law Commission has taken steps to remove the unfairness. Removing this unfairness, should remove this contradiction and allow for Islamic policies to be applied in the English legal system without any barrier unless the contradiction is based on the operational differences. However, the Islamic insurers should incorporate certain terms in the contract until this unfairness is removed from the English insurance law.

### 5.1 Remedy against the Insured

#### 5.1.1 English Law

It is stated in the previous chapter that the duty of both insured and insurer imposed by section 17 of Marine Insurance Act 1906 is to observe utmost good faith. The section also provides the remedy for breach of this duty saying 'if the utmost good faith be not observed by either party, the contract may be avoided by the other party'. It has also been explained in

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<sup>558</sup> *Drake Insurance Plc v Provident Insurance Plc* [2003] EWCA Civ 1834; [2004] 1 Lloyd's Rep 268 [145] (Clarke LJ).

<sup>559</sup> Matthew Ellis, 'Utmost good faith: The scope and application of s 13 of the Insurance Contracts Act in the wake of *CGU v AMP*' (2009) 20 ILJ 92, 92.

<sup>560</sup> R. A. Hasson, 'The Doctrine of Uberrima Fides in Insurance Law- A Critical Evaluation' (1969) 32 MLR 615, 615.

the previous chapter that section 18 specified the duty of the insured stating that the insured must disclose every material fact to the insurer. The section then provides the remedy for a breach of this duty stating that if ‘the assured fails to make such disclosure, the insurer may avoid the contract’. The remedy is always same regardless the insured’s intention behind the performance of the duty. In *Becker v Marshall*<sup>561</sup> the plaintiff was asked whether he had ever sustained a loss. The plaintiff communicated the losses to the defendant’s agent and the agent said it did not matter and answered ‘No’ to the question where plaintiff signed it. The judge did not find the plaintiff guilty of anything in the nature of bad faith, but still allowed the insurer to avoid the contract for nondisclosure of material fact. The Court of Appeal approved the decision.<sup>562</sup> The same remedy also applies when the plaintiff fails to disclose a fact due to being confused as to whether the fact is material or not. In *Brotherton v Aseguradora Colseguros SA*<sup>563</sup> the reinsureds failed to disclose a groundless allegation which they believed to be immaterial due to its falsity. Nonetheless, the court allowed the avoidance. Lord Mansfield justified such remedy holding that

[I]nsurance is a contract upon 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 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. Keeping back such circumstance is a fraud, and, therefore, the policy is void. Although the suppression should happen through mistake without any fraudulent intention, yet still the underwriter is deceived...The avoidance is allowed because the courts find that hiding material information from the insurer is nothing but fraud. The insurer is deceived no matter how honest the insured is or how minor or inconsequential the matter is.<sup>564</sup>

However, the courts applied the ‘inducement test’ that allows the insurer to avoid the contract only for those material non-disclosures without which the insurer would not have entered into

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<sup>561</sup> (1922) 11 Ll. L. Rep. 114. See also *Paxman v Union Assurance Society Ltd* (1923) 39 TLR 424; 15 Ll L Rep 206, 207 (McCardie J); *Lee v British Law Insurance Co Ltd* [1972]2 Lloyd’s Rep 49, 57; *Berger v Pollock* [1973]2 Lloyd’s Rep. 442, 460 (Kerr J) where the existence of open cover could not relieve the plaintiff from avoidance; *Container Transport International Inc v Oceanus Mutual Underwriting Association (Bermuda) Ltd* [1984]1 Lloyd’s Rep 476, 525 (Stephenson LJ); *Cf Gate v Sun Alliance Insurance Ltd* [1995] LRLR 385, 399 (Fisher J).

<sup>562</sup> (1922) 12 Ll. L. Rep. 413.

<sup>563</sup> [2003] EWHC 335 (Comm), [2003] 2 C.L.C. 629 [26] (Moore-Bick J); see also *March Cabaret Club & Casino Ltd v The London Assurance* [1975]1 Lloyd’s Rep 169, 177 (May J); *Contra Reynolds v Phoenix Assurance Co Ltd* [1978]2 Lloyd’s Rep 440, 459-460 (Forbes J); *Container Transport International Inc v Oceanus Mutual Underwriting Association (Bermuda) Ltd* [1984] 1 Lloyd’s Rep 476, 506 (Parker LJ); *Sharp v Sphere Drake Insurance Plc; The Moonacre* [1992]2 Lloyd’s Rep 501, 521 (Mr Colman QC); *Contra Gate v Sun Alliance Insurance Ltd* [1995] LRLR 385, 400 (Fisher J).

<sup>564</sup> *Carter v Boehm* (1766) 97 E.R. 1162, 1164 (Lord Mansfield).

the contract at all or would have done so only on different terms. The House of Lords held in *Pan Atlantic Insurance Co Ltd v Pine Top Insurance*<sup>565</sup> that for an insurer to be entitled to avoid a policy for misrepresentation or non-disclosure, not only did the misrepresentation or non-disclosure have to be material, but, in addition it had to have induced the making of the policy on the relevant terms. Accordingly, an underwriter who was not induced by the misrepresentation or non-disclosure of a material fact to make the contract could not rely on that misrepresentation or non-disclosure to avoid the contract.

In *Drake Insurance v Provident Insurance plc*<sup>566</sup> K seriously injured a cyclist B whilst driving her husband, S's car. She and her husband S had separate insurances. Drake covered K whilst she was driving any vehicle with the owner's consent. Provident covered S, but also K as a named driver. In September 1996, B commenced proceedings against K and Drake settled the claim. Drake then sought a 50 per cent contribution from Provident. Provident denied liability on two grounds but, for present purposes, the one relevant here was an alleged pre-contractual non-disclosure by S of a speeding conviction incurred by K, which they said, was both material and induced them to enter into the contract. There was no question about the materiality of speeding conviction, so the court focused on the inducement issue. Provident's underwriting policy was based on point system, allocated according to particular risks. A normal premium was charged if the insured had 17 points or fewer, with those over 17 points attracting a 25 per cent increase in their premiums. An accident attracted 15 points and a speeding conviction attracted 10 points. K was involved in an accident in 1994, which S disclosed when taking the original policy. He failed to inform the insurer at the time of renewal in February 1996 that K was found not guilty. A normal premium was charged in February 1996 since the accident attracted 15 points. However, S received a speeding conviction in December 1995 which he failed to disclose at the time of renewal in February 1996. If he had disclosed that K was found not guilty the point would have been 0. However, the actual point should have been 10 had he disclosed his speeding conviction. Consequently, the rate of premiums would not have been increased had S disclosed his conviction. The court, applying the test of *Pin Top*,<sup>567</sup> held that the insurer was not induced in weighing up the risk for the non-disclosure of the fact and as such could not avoid the contract on that ground. The court then confirmed that the party seeking to rely upon the

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<sup>565</sup> [1995] 1 AC 501, [1994] 3 All ER 581, [1994] 3 WLR 677.

<sup>566</sup> [2003] EWCA Civ 1834, [2004] Lloyd's Rep I.R 277.

<sup>567</sup> *Pan Atlantic Insurance Co v Pine Top Insurance Co* [1994] 3 All ER 581

breach must prove the inducement. This decision gave the ‘inducement requirement real “teeth” and is certainly close to the reasoning of the House of Lords in *Pan Atlantic* when inducement was first introduced into the law in this area’.<sup>568</sup>

### 5.1.1.1 Critical Analysis of the Current Law

Courts and academics view the current remedy as harsh. The courts have expressed their view by stating that it is a, ‘powerful weapon placed by law in the hands of the insurer’,<sup>569</sup> or, variously a ‘drastic remedy’,<sup>570</sup> ‘penal’,<sup>571</sup> ‘extreme’,<sup>572</sup> and ‘draconian’.<sup>573</sup> The harshness of the remedy has been supported by those arguing that it is required to stop the fraudulent act of non-disclosure.<sup>574</sup> The act that deceives the insurer is said to be fraudulent no matter whether the insured acted with an honest mind.<sup>575</sup> The remedy is to stop deceiving the insurer by deterring the ‘assureds or brokers adopting a more cavalier or sharp attitude to their responsibilities *vis-a-vis* the insurer’.<sup>576</sup> In whatever manner the courts or academics attempt to justify this harsh remedy it is unjustifiable, unreasonable and disproportionate. Such as, the same remedy<sup>577</sup> is applicable for the fraudulent, negligent or honest breach.<sup>578</sup> It is unjustifiable and disproportionate for the honest insured to be treated in the same way to that of the fraudulent insured. In *Locker and Woolf v Western Australian Insurance Company*<sup>579</sup> the insured took out fire insurance and was asked a general question i.e. whether any of his insurance proposals have been declined by any other company. The insured answered ‘No’ to that question. It subsequently appeared that his proposal for motor insurance was declined in

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<sup>568</sup> Norma J. Hird, ‘Utmost good faith – forward to the past’ [2005] JBL 257, 260.

<sup>569</sup> *Container Transport International Inc v Oceanus Mutual Underwriting Association (Bermuda) Ltd* [1982]2 Lloyd’s Rep 178, 187 (Lloyd J).

<sup>570</sup> *Kausar v Eagle Star Insurance Co Ltd* [1997] CLC 129, 132-133 (Staughton LJ).

<sup>571</sup> *Manifest Shipping Co Ltd v Uni-Polaris Shipping Co Ltd; The Star Sea* [2001] UKHL 1; [2001]2 WLR 170 [51] (Lord Hobhouse).

<sup>572</sup> *K/S Merc-Scandia XXXXII v Certain Lloyd’s Underwriters; The Mercandian Continent* [2001] EWCA Civ 1275; [2001]2 Lloyd’s Rep 563, [26] (Longmore LJ).

<sup>573</sup> *Drake Insurance Plc v Provident Insurance Plc* [2003] EWCA Civ 1834; [2004] 1 Lloyd’s Rep 268 [145] (Clarke LJ).

<sup>574</sup> See, Law Commission and Scottish Law Commission, *Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured*, (Consultation Paper No 182; Discussion Paper No. 134, 2007) para 4.3.

<sup>575</sup> *Carter v Boehm* (1766) 97 E.R. 1162, 1164 (Lord Mansfield).

<sup>576</sup> Peter Macdonald Eggers, Simon Picken and Patrick Foss *Good Faith and Insurance Contracts* (2nd edn, LLP 2004) 441.

<sup>577</sup> Subject to the condition that the insurer satisfies the inducement test laid down in *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* [1995] AC 501.

<sup>578</sup> See for instance, *Becker v Marshall* (1922) 11 Ll. L. Rep. 114; *Paxman v Union Assurance Society Ltd* (1923) 39 TLR 424; *Lee v British Law Insurance Co Ltd* [1972]2 Lloyd’s Rep 49; *Berger v Pollock* [1973]2 Lloyd’s Rep. 442; *Brotherton v Aseguradora Colseguros SA* [2003] EWHC 335 (Comm), [2003] 2 C.L.C. 629; *Insurance Corporation of the Channel Islands v Royal Hotel* [1998] Lloyd’s Rep IR 151.

<sup>579</sup> [1936] 1 K.B. 408.

1930 on the grounds of misrepresentations or untrue answers and non-disclosure. The counsel of the insured argued that if ‘the insurance companies desire to have information as to other insurances, they should make this clear’.<sup>580</sup> The Court of Appeal refused the argument holding that the duty of disclosure ‘is not limited to matters exclusively relating to fire risks, but extends to any matter which would influence the judgment of the insurance company in deciding whether to take or refuse the risk’. As such the insurer is allowed to receive a remedy by confusing an insured with ambiguous question.

It has been discussed in the previous chapter that the ambiguous question was also asked in *Glicksman v Lancashire and General Assurance Co, Ltd.*<sup>581</sup> In this case Lord Atkinson acknowledged that the question was vague and said,

I think it is a lamentable thing that insurance companies will abstain from shaping the questions they put to intending insurers on such occasions in clear and unambiguous language. For instance, in this particular case, all that it was necessary to say was, ‘Did you two or either of you make an application to the Sun Insurance Co for a policy against burglary?’ This whole case and all the expense would have been prevented had that simple method been adopted.<sup>582</sup>

Nonetheless the House of Lords, affirming the decisions of Court of Appeal, held that the insurer can avoid the contract even if ‘you’ were to be read in plural. This decision clarifies that the insured shall be punished under English law for failing to answer accurately even if the question is vague. As such the insurer is unjustifiably favoured by the law.<sup>583</sup>

Further, if the insured is refused by the earlier insurer for arbitrary or capricious reasons, it would be unjustified to penalise the insured for nondisclosure of that earlier capricious refusal. On the other, if the previous refusal was made for good cause then the insurer shall lose its chance to make further investigations if it is undisclosed. Hence the law should be changed to make fair balance between the interests of these two parties in terms of remedies.

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<sup>580</sup> Similar vague questions are still asked by the insurers. See for instance <<https://uk2.directline.com/insurance/home/PLB92573849569674849202/yourdetails.do;jsessionid=28301ec788973e293067>> , <<https://mygocompare.gocompare.com/SecuredPages/NewCustomer.aspx?product=3&cookieCheck=true>> accessed to both sites on 17/04/2013.

<sup>581</sup> [1926] All ER Rep 161, [1927] AC 139.

<sup>582</sup> [1927] A.C. 139, 144.

<sup>583</sup> R.A. Hasson Commented in ‘The Doctrine of Uberrima Fides In Insurance Law- A Critical Evaluation’ (1969) 32 MLR 615-37, 623 ‘It is respectfully submitted that the House of Lords erred in this case by allowing the insurer to have the best of both worlds; this should not have been permitted even if the insured had been a person of greater sophistication than the illiterate tailor in *Glicksman v. Lancashire and General Insurance Co.*’

The above analysis has proved the remedy as ‘unbalanced’ and ‘one sided’,<sup>584</sup> as ‘it favours the insurer and not the assured’.<sup>585</sup> It is unreasonable since it provides the same remedy for different categories of fault. The above analysis further proves that the remedy given by the current law is so unjustified that it throws the insured into the new risk that the insurer might seek to deny a claim on the policy by seeking to avoid the contract by raising the issue of breach of duty that the insured never realised. This new risk is potentially worse than the risk he is seeking to insure. In the case of the uninsured risk he may suffer the losses that he is seeking to insure against, whereas with that new risk he may suffer those financial losses as well as mental depression for not being covered by the policy. Moreover, he fails to utilise the premiums that he pays throughout the policy whilst the insurer gets the chance of utilising them without any cost. As a result, it is claimed that, the current remedy is nothing but a trap for an insured.<sup>586</sup>

However, the ‘inducement test’ has, partially reduced the bad effect of the current law. According to the decision in *Drake Insurance v Provident Insurance plc*<sup>587</sup> insurers in the above mentioned scenarios will not be able to avoid the contract if it is found that the undisclosed facts would not have induced the insurers in taking those policies. This is the argument that an insured has to avoid the harsh effects of the current remedy.

### **5.1.1.2 Remedy Proposed by the Bill<sup>588</sup>**

Finding the difficulties of the current law the two Law Commissions proposed a change to the current remedy and this was published as a Bill in December 2009.<sup>589</sup> The Bill proposed that the insurer, in order to be eligible for the remedy, has to prove that the insured has breached their duty of ‘taking reasonable care not to make a misrepresentation’<sup>590</sup> in

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<sup>584</sup> *Manifest Shipping Co Ltd v Uni-Polaris Shipping Co Ltd; The Star Sea* [2001]UKHL 1; [2001]2 WLR 170, [57] (Lord Hobhouse); *Drake Insurance plc v Provident Insurance plc* [2003] EWCA civ 1834; [2004]1 Lloyd’s Rep 268, [83] (Rix LJ).

<sup>585</sup> Peter Macdonald Eggers, Simon Picken and Patrick Foss *Good Faith and Insurance Contracts* (2nd edn, LLP 2004) 441.

<sup>586</sup> See, Christopher Butcher, ‘Good faith in insurance law: a redundant concept?’ (2008) JBL 375, 379.

<sup>587</sup> [2003] EWCA Civ 1834, [2004] Lloyd’s Rep I.R 277.

<sup>588</sup> The Bill was entitled ‘Consumer Insurance (Disclosure and Representations) Bill’. It has come into force as an Act being entitled ‘Consumer Insurance (Disclosure and Representations) Act 2012’ on 6 April 2013 without any change to the sections that are referred in this thesis. Since the original text was completed on 1<sup>st</sup> December 2011 the Bill is referred instead of the Act.

<sup>589</sup> Law Commission and Scottish Law Commission, *Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation* (Law Com No 319, Scot Law Com No. 219, 2009).

<sup>590</sup> Consumer Insurance (Disclosure and Representations) HL Bill (2010-2012) 68, clause 3(1).

answering the questions made by the insurer.<sup>591</sup> In deciding whether the insured has breached the duty the relevant circumstances should be taken into account<sup>592</sup> considering the standard of a reasonable consumer.<sup>593</sup> Once it is found in the eye of a reasonable insured that the alleged insured has misrepresented then it is required to find whether this has induced the insurer.<sup>594</sup> This test is similar to the inducement test provided by the court in *Pan Atlantic*.<sup>595</sup> The insurer shall be considered to be eligible for the remedy if both of these tests are proved and the alleged misrepresentation is termed as a ‘qualifying misrepresentation’.

Once it is established that the insurer is eligible to remedy then further 2 tests should be applied to determine the value of the remedy,<sup>596</sup> firstly, whether the qualifying misrepresentation was made deliberately or recklessly or whether it is made carelessly. A qualifying misrepresentation shall be deliberate or reckless if the consumer ‘(a) knew that it was untrue or misleading, or did not care whether or not it was untrue or misleading, and (b) knew that the matter to which the misrepresentation related was relevant to the insurer, or did not care whether or not it was relevant to the insurer’.<sup>597</sup> If it is not proved to be deliberate or reckless, it is careless.<sup>598</sup>

If the insurer successfully proves that the qualifying misrepresentation was made deliberately or recklessly,<sup>599</sup> he may avoid the contract as it did not exist,<sup>600</sup> ‘even if it results in over-compensating the insurer for the loss they have suffered’.<sup>601</sup> The insurer is also able to retain the premiums paid by the insured,<sup>602</sup> ‘to show society’s disapproval of the behaviour and to

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<sup>591</sup> According to their proposal the insured does not need to volunteer information except answering the question asked by the insurer with reasonable care. See for instance *Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation* (Law Com No 319, Scot Law Com No. 219, 2009) para 4.3.

<sup>592</sup> Consumer Insurance (Disclosure and Representations) HL Bill (2010-2012) 68, clause 2(2).

<sup>593</sup> *ibid* cl. 3(3).

<sup>594</sup> *ibid* cl. 4(1).

<sup>595</sup> *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* [1995] AC 501. See for instance, *Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation* (Law Com No 319, Scot Law Com No. 219, 2009) para A.22.

<sup>596</sup> Consumer Insurance (Disclosure and Representations) HL Bill (2010-2012) 68, clause 5(1).

<sup>597</sup> *ibid* cl. 5(2).

<sup>598</sup> *ibid* cl. 5(3).

<sup>599</sup> The insurer is under the duty to prove that the misrepresentation was deliberate or reckless. See, *Consumer Insurance (Disclosure and Representations) HL Bill (2010-2012) 68, cl. 5(4)*.

<sup>600</sup> Consumer Insurance (Disclosure and Representations) HL Bill (2010-2012) 68, Sched 1, para 2 (a).

<sup>601</sup> See, Law Commission and Scottish Law Commission, *Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured*, (Consultation Paper No 182; Discussion Paper No. 134, 2007) para 4.50.

<sup>602</sup> Consumer Insurance (Disclosure and Representations) HL Bill (2010-2012) 68, Sch 1 para 2(b).

deter wrongdoing'.<sup>603</sup> However, if retaining premiums is proved to be unfair to the consumer, the premiums should be returned.<sup>604</sup>

If it is proved that the qualifying misrepresentation was careless the insurer would be placed in a position where he would have been had the insured complied with the duty.<sup>605</sup> To place him in that position the following scenarios are required to be considered:

5. If the insurer would not have entered into the consumer insurance contract on any terms, the insurer may avoid the contract and refuse all claims, but must return the premiums paid.

6. If the insurer would have entered into the consumer insurance contract, but on different terms (excluding terms relating to the premium), the contract is to be treated as if it had been entered into on those different terms if the insurer so requires.

7. In addition, if the insurer would have entered into the consumer insurance contract (whether the terms relating to matters other than the premium would have been the same or different), but would have charged a higher premium, the insurer may reduce proportionately the amount to be paid on a claim.<sup>606</sup>

In their drafted Bill the Law Commission<sup>607</sup> considered the issue of cut-off period<sup>608</sup> in the case of a careless misrepresentation in life policy. Under this scheme an insurer loses his right to refuse claim after a set period. The Law Commission, in their drafted Bill, termed this approach as 'arbitrary.'<sup>609</sup> Consequently, the cut-off period was not proposed in the Bill.

### 5.1.1.3 Critical Analysis of the Law Proposed by the Bill

According to the proposed Bill, the insurer shall be allowed to avoid the contract if the insured deliberately or recklessly makes qualifying misrepresentation. The Bill also proposed that the insurer shall be allowed to retain the premiums unless it is unfair for the insured. The remedy is therefore same for both deliberate act and reckless act. Needless to say that the

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<sup>603</sup>Law Commission and Scottish Law Commission, *Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation* (Law Com No 319, Scot Law Com No. 219, 2009) para 4.20.

<sup>604</sup> Consumer Insurance (Disclosure and Representations) HL Bill (2010-2012) 68, Sch 1, para 2 (b).

<sup>605</sup> *ibid* Sch 1, para 4.

<sup>606</sup> *ibid* Sch 1, paras 5-7.

<sup>607</sup> Law Commission and Scottish Law Commission, *Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation* (Law Com No 319, Scot Law Com No. 219, 2009).

<sup>608</sup>The issue related to this 'cut-off period' will be referred in four more places so as to get it adequately analysed, these are: 1) criticising the Law Commission's view related to 'cut-off period'; 2) in order to provide author's recommendation related to this issue; 3) to discuss the position of the Shariah in this case; 4) in conclusion so as to summaries author's view in this regard

<sup>609</sup> Law Commission and Scottish Law Commission, *Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation* (Law Com No 319, Scot Law Com No. 219, 2009) paras, 1.19, 4.53.



seriousness of both the deliberate and reckless breach is different and as such it is argued that the remedy should also be different. Further to that, the Law Commission did not provide any guideline to decide when it should be unfair to retain the premiums. There is no doubt that every insurer shall want to keep the premiums and it is the insured who shall claim it back raising the issue of unfairness. If the insurer refuses to pay them back, the insured may go to the court to resolve the issue. If the insured brings the case to the court it may cost him more than the amount he is aiming to recover and there is always a risk of losing the case. Consequently, it is likely that the insured will give up his claim for the recovery of premiums leading to further injustice to him.

The proposed remedy for careless misrepresentation sounds to be reasonable. However, the Bill did not propose any remedy where the insured acts honestly and reasonably,<sup>610</sup> but still fails to disclose a material fact or misrepresents which induced the insurers, leaving the insurer under obligation to pay full claim irrespective of the seriousness of nondisclosure or misrepresentation.<sup>611</sup> Consequently, the insured is in the position of receiving sympathy stepping on the shoulder of the insurer causing unfairness to the insurer.

The remedy is further disproportionate in following scenarios:

- 1) A, being honest and reasonable, fails to disclose a material fact or misrepresents about a fact that is of such seriousness that the insurer would have refused the contract had he known the fact before making contract.
- 2) B, being honest and reasonable, fails to disclose a material fact or misrepresents about a fact that is less serious than that of the first one that the insurer would have changed the terms of the contract or increased premium had he known the fact.
- 3) C, being honest and reasonable, fails to disclose a material fact or misrepresents about a fact that is minor that the insurer would not have made any change in the contract had he known the fact.

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<sup>610</sup> Clause 2(2), of the Consumer Insurance (Disclosure and Representations) HL Bill (2010-2012) 68, states that the duty of the insured is 'to take reasonable care not to make a misrepresentation'. Consequently, the person who fails to disclose or misrepresents after taking reasonable care i.e. who acts honestly and reasonably should not be liable for breach of duty.

<sup>611</sup> In the consultation paper they proposed, following the FSA approach, that the insurer shall not have any remedy for misrepresentation made innocently and negligently by the insured. See for instance, Law Commission and Scottish Law Commission, *Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured*, (Consultation Paper No 182; Discussion Paper No. 134, 2007) paras 4.100 - 4.129. It is to be noted that 'no remedy' for insurer is itself a remedy which is to pay full claim.

Yet, in all of these cases, according to the proposed law, the insurer has to pay the full claim. Needless to say, the effect of nondisclosure or misrepresentation is not same in scenarios 1 and 3. The loss and suffering of the insurer in consequence of A's non-disclosure or misrepresentation is much more serious than that of C, whereas both situations are considered with similar value. Hence, the remedy is disproportionate.

Following the Law Commission's disapproval the Bill did not include cut-off period in life policy. Whereas the Law Commission proposed in their first consultation paper a cut off period of 3 years.<sup>612</sup> They changed the period to 5 years in their Consultation paper No. 182 stating that assessment of innocence and negligence after long period is 'unreal' and 'unfair'.<sup>613</sup> In the Bill, that they have drafted, they considered this approach as 'arbitrary'.<sup>614</sup> Whereas, on two occasions they considered that as necessary and referred to the position of other countries.<sup>615</sup> For example, many US jurisdictions impose a 'cut off' period of 2 years and the laws of New Zealand and Australia do so for 3 years.<sup>616</sup> In Germany the cut off period is 5 years for all types of insurance.<sup>617</sup>

The rule of cut off period in the life insurance is defended by showing the extreme difficulty of assessing the reasonableness of statement made many years ago by the insured who is now deceased.<sup>618</sup> Further, the assessment of innocence and reasonableness after a long period in such circumstances is seemed to be 'unreal' and 'unfair'.<sup>619</sup> Considering such consequences the above-mentioned countries apply the 'cut off' period. Whilst the above mentioned countries are applying the cut off period and the Law Commission proposed it in two

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<sup>612</sup> Law Commission and Scottish Law Commission, *Misrepresentation and Non-Disclosure* (Insurance Contract Law, Issues Paper 1, 2006) Para 6.129.

<sup>613</sup> See, Law Commission and Scottish Law Commission, *Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured*, (Consultation Paper No 182; Discussion Paper No. 134, 2007) para 4.190.

<sup>614</sup> Law Commission and Scottish Law Commission, *Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation* (Law Com No 319, Scot Law Com No. 219, 2009) paras, 1.19, 4.53.

<sup>615</sup> See, Law Commission and Scottish Law Commission, *Misrepresentation and Non-Disclosure* (Insurance Contract Law, Issues Paper 1, 2006) Para 6.127; Law Commission and Scottish Law Commission, *Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured*, (Consultation Paper No 182; Discussion Paper No. 134, 2007) paras 4.192- 4.193.

<sup>616</sup> See, Law Commission and Scottish Law Commission, *Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured*, (Consultation Paper No 182; Discussion Paper No. 134, 2007) paras 4.192- 4.193.

<sup>617</sup> See, *ibid* para 4.193.

<sup>618</sup> See, *ibid* para 4.190.

<sup>619</sup> See, *ibid* para 4.190.

consultation papers finding it necessary, how this policy has become 'arbitrary' in the eye of the same Law Commission when they were drafting the Bill?

### **5.1.2 The Legal Position in Australia**

The Insurance Contracts Act 1984 provides an almost similar remedy for both the life and general policies. Section 28 (2), and section 29 (2) in the case of life policies, allow the insurer to avoid the contract only in the case of fraudulent non-disclosure or misrepresentation. In other cases of general insurance policy, like innocent or negligent misrepresentation, 'the liability of the insurer in respect of a claim is reduced to the amount that would place the insurer in a position in which the insurer would have been if the failure had not occurred or the misrepresentation had not been made'.<sup>620</sup> The section 28 (3) states that the insurer shall have the same remedy if the insurer does not avoid the contract where he is allowed to. In the case of a life policy where the breach is caused by innocent or negligent breach and it is found that 'the insurer would not have been prepared to enter into a contract of life insurance with the insured on any terms if the duty of disclosure had been complied with or the misrepresentation had not been made, the insurer may, within 3 years after the contract was entered into, avoid the contract'.<sup>621</sup>

However, section 31 provides the court with discretion both in general and life policies to disregard the avoidance, which is only done on the ground of fraudulent breach, if it would be harsh and unfair not to do so. The court may apply this power if it finds that 'the insurer has not been prejudiced by the failure or misrepresentation or, if he has been so prejudiced, the prejudice is minimal or insignificant'. With this power the court may allow the insured to recover the whole or such part as the court thinks just and equitable according to the circumstances.

Section 28 (1) and section 29 (1) (c) in the case of life policy of the Act impose the inducement test and as such the insurer is not allowed to any remedy if he is not affected by the non-disclosure or misrepresentation in deciding to accept the risk and the terms on which he or she will do so.<sup>622</sup>

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<sup>620</sup> Section 28 (3) of Insurance Contracts Act 1984.

<sup>621</sup> Section 29 (3) of Insurance Contracts Act 1984. The Insurance Contracts Amendment Bill 2013 proposed to repeal the subsection and substitute by '(3) If the failure was not fraudulent or the misrepresentation was not made fraudulently, the insurer may, within 3 years after the contract was entered into, avoid the contract.'

<sup>622</sup> *Visscher Enterprises Pty Ltd v Southern Pacific Insurance Co Ltd* [1981] Qd R 561.

### 5.1.3 Criticism of the Law of Australia

In the case of general insurance the insurer is not allowed to avoid the contract where the insured is innocent or negligent, but in practice the insurer avoids the contract through the reduction of liability to nil when it is found that the insurer would not have taken the policy had the insured not breached the duty.<sup>623</sup> Consequently, stating that the avoidance is only for fraudulent breach is superfluous.

Moreover, the law imposes a similar remedy for innocent and negligent breach. For example A has appointed an independent surveyor to check whether the crack in the house is a sign of subsidence or not. The surveyor reported in negative and A answered in the proposal form accordingly. Subsequently, it was discovered that the report was wrong. If the insurer had known that the house has got the sign of subsidence he would not have taken the policy. The liability of the insurer shall be reduced to nil meaning it to be avoidance. If A had not appointed the surveyor and negligently answered in the negative, the liability of insurer shall still be reduced to nil. Hence, it is argued that the law is causing injustice to the person who is acting honestly and reasonably. Further to that the law is effectively discouraging the person to be sensible and encouraging to be negligent.

### 5.1.4 Recommendation

The remedies have been analysed above, from the perspective of English law, proposal to reform English law from the Law Commission, and Australian law. However, the discussion above finds that none of them are free from loopholes. In light of these loopholes, the author recommends the following remedies closing the loopholes and establishing a fair balance between the parties.

- i. If the insured fraudulently breaches his duty the insurer shall be allowed to avoid the contract and not be bound to return the premium.*
- ii. If the insured recklessly breaches his duty the insurer shall be allowed to avoid the contract, but must return the premiums.*

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<sup>623</sup> See, *Ferrcom Pty Ltd v Commercial Union Assurance Co of Australia Ltd* (1989)5 ANZ Ins Cas 60-907; *Lindsay v CIC Insurance Ltd* (1989)5 ANZ Ins Cas 60-913; *Ayoub v Lombard Insurance Co (Aust) Pty Ltd* (1989)5 ANZ Ins Cas 60-933; *Alexander Stenhouse Ltd v Austcan Investments Pty Ltd* (1993) 67 ALJR 421.

- iii. *If he negligently breaches the duty, the insurer, alike recommended by the Law Commission, shall be restored by 100% to the position where he should have been had no misrepresentation or non-disclosure been made.*
- iv. *If he innocently breaches his duty and it is found that the insurer would not have entered into the contract had there been no breach the insurer shall pay 50% of the claim.<sup>624</sup> If it is found that the insurer would have made changes in the contract had there been no breach the insurer would be restored by 50% to the position where he should have been had no misrepresentation or nondisclosure been made.<sup>625</sup> If it is found that the insurer would have accepted the policy without making any change in the contract the insurer must pay the full claim.*
- v. *In the case of negligent non-disclosure or misrepresentation in insurance of mortality a 3-year cut off period should be applied, after which period the insurer shall not be allowed to avoid the contract.*

### **5.1.5 Remedy under Shariah Principles**

Professor Ma'sum Billah suggested three possible remedies for non-disclosure of a material fact.<sup>626</sup> Firstly, that the 'policy should be cancelled and be treated as void',<sup>627</sup> here he referred two Ahadith,<sup>628</sup> where Prophet Muhammad (PBUH) ordered to disclose every defect of the product. Another option is for the policy to be voidable. However, if the innocent party decides to retain it 'he should have the right to claim from the other party the necessary compensation if any'.<sup>629</sup> The final possibility is for the policy to be avoided and 'the paid-contributions should be returned to the policyholder together with the profits and bonuses made over the paid-contributions after a deduction of the charges due to the company'.<sup>630</sup> It is apparent that his recommendation is mainly based on avoidance. Whereas, the remedy of

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<sup>624</sup> For example, where the claim is for £50,000, the insurer shall pay £25,000.

<sup>625</sup> For example, had the insurer known the fact he would have increased premium by £1,000 each month. The insurer shall be entitled to receive £500 extra in each month which should be set-off from the claimed amount. If it is found that the insurer would have changed the term of the contract, he shall be restored by 50% to the position where he would have been had that term been breached.

<sup>626</sup> Professor Ma'sum Billah, *Islamic and Modern Insurance Principles and Practices*, (Ilmiah Publishers, Malaysia, 2003) 221-222.

<sup>627</sup> *ibid* 221.

<sup>628</sup> 1) Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari* (Dr. M Muhsin Khan tr) Kitab al-Buyu, Voll III, No. 292, pp 165-166; 2) Maulana Fazlul Karim (tr), *Mishkatul Masabih*, Kitab al-Buyu, No. 55, p. 284.

<sup>629</sup> Professor Ma'sum Billah, *Islamic and Modern Insurance Principles and Practices*, (Ilmiah Publishers, Malaysia, 2003) 222.

<sup>630</sup> *ibid* 222.

‘avoidance’ disregarding the nature of the breach causes serious injustice as analysed above. Injustice is strictly prohibited by Allah (SWT). As He says

ويقوم أوفوا المكيال والميزان بالقسط ولا تبخسوا الناس أشياءهم ولا تعثوا في الأرض مفسدين  
بقيت الله خير لكم إن كنتم مؤمنين

*[Prophet Shu’ayb said his people] And, O my people, give full measure and weight justly, and defraud not men of their things, and act not corruptly in the land making mischief. What remains [lawful] from Allah is better for you, if you are believers.*<sup>631</sup>

The Holy Qur’an enunciates 4 fundamental principles of commerce from the words of Hadrat Shu’aib.<sup>632</sup> These are:

i) ‘To give just measure and weight.’

In an insurance policy both the insured and insurer should be paid with what they actually deserve. Where the non-disclosed fact is minor and the insurer would have accepted the policy without making any change had he been informed about it before making the policy, the avoidance for that non-disclosure shall benefit him more than he deserves depriving the insured. Consequently, the avoidance cannot be the only remedy for Islamic policies.

ii) ‘Not to withhold from the people the things that are their due.’

Where the insured innocently fails to disclose a fact and the fact is minor as in the above case, the insured should be paid his claim since it is his due in every sense.

iii) ‘Not to commit evil on the earth with the intent of doing mischief.’

In an insurance contract no party is allowed to act fraudulently. If the insured fraudulently breaches his duty avoidance should be an adequate remedy.

iv) ‘To be contented with the profit that is left with us by God after we have paid other people their due.’

In an insurance contract both the insured and insurer should be happy with the remedy that complies with Shariah principles.

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<sup>631</sup> *The Holy Quran*, 11: 85-86.

<sup>632</sup> Abdul Hamid Siddiqi (tr), *Sahih Muslim* (SH. Muhammad Ashraf, Kashmiri Bazar, Lahore, Pakistan 1973) Vol III, 792.

It is worth re-quoting the statement of Abu'l-Husain 'Asakir-ud-Din Muslim where he said 'All transactions should be based on the fundamental principle of "Ta'auanu ala birri wa't-taqwa" (mutual co-operation for the cause of goodness or piety). A transaction not based upon this sound principle is not lawful'.<sup>633</sup> He also said that 'Islam tries to be fair to both parties to a transaction. Any step on the part of one, that is advantageous to him and disadvantageous to the other, is not permissible'.<sup>634</sup>

The aforementioned texts have made it clear that the law should not impose something on the insured or insurer that may become advantageous for one and troubles for another causing injustice. Avoidance for every kind of non-disclosure shall cause injustice to the insured and as such the remedy recommended by Professor Ma'sum Billah should not be acceptable under Islamic law. Moreover, he recommended that the innocent party should get compensation if he chooses not to avoid the contract. The professor did not suggest how this compensation should be determined. It is therefore argued that there are some gaps left in this recommendation.

According to the analysis above, the remedy should vary following the nature of the breach so as to establish justice in both parties. Hence, the author considers that there should be different remedy for different degree of breaches in an Islamic insurance contract.

#### *Fraudulent nondisclosure or misrepresentation*

The following Hadith makes it clear that the intentional concealment of material fact i.e. fraudulent non-disclosure or misrepresentation makes the contract voidable.

حَدَّثَنَا عَلِيُّ بْنُ عَبْدِ اللَّهِ حَدَّثَنَا سُفْيَانُ قَالَ قَالَ عُمَرُ وَكَانَ هَا هُنَا رَجُلٌ اسْمُهُ نَوَّاسٌ وَكَانَتْ عِنْدَهُ إِبِلٌ هَيْمٌ فَذَهَبَ ابْنُ عُمَرَ رَضِيَ اللَّهُ عَنْهُمَا فَاسْتَتَرَى تِلْكَ الْإِبِلَ مِنْ شَرِيكِ لَهُ فَجَاءَ إِلَيْهِ شَرِيكُهُ فَقَالَ بَعْنَا تِلْكَ الْإِبِلَ فَقَالَ مِمَّنْ بَعْتَهَا قَالَ مِنْ شَيْخٍ كَذَا وَكَذَا فَقَالَ وَيْحَكَ ذَلِكَ وَاللَّهِ ابْنُ عُمَرَ فَجَاءَهُ فَقَالَ إِنَّ شَرِيكَسَ بَاعَكَ إِبِلًا هَيْمًا وَلَمْ يَعْرِفَكَ قَالَ فَاسْتَتَفَهَا قَالَ فَلَمَّا ذَهَبَ يَسْتَأْفَهَا فَقَالَ دَعْمَا رَضِينَا بِقَضَاءِ رَسُولِ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ لَا عُدْوَى

*Narrated by 'Amr Here (i.e. in Mecca) there was a man called Nawwas and he had camels suffering from the disease of excessive and unquenchable thirst. Ibn 'Umar went to the partner of Nawwas and bought those camels. The man returned to Nawwas and told him that*

<sup>633</sup> Abdul Hamid Siddiqi (tr), *Sahih Muslim* (SH. Muhammad Ashraf, Kashmiri Bazar, Lahore, Pakistan 1973) Vol III, 792.

<sup>634</sup> *ibid* 795.

he had sold those camels. Nawwas asked him, 'To whom have you sold them?' He replied, 'To such and such Sheikh.' Nawwas said, 'Woe to you; By Allah, that Sheikh was Ibn 'Umar.' Nawwas then went to Ibn 'Umar and said to him, 'My partner sold you camels suffering from the disease of excessive thirst and he had not known you.' Ibn 'Umar told him to take them back. When Nawwas went to take them, Ibn 'Umar said to him, 'Leave them there as I am happy with the decision of Allah's Apostle that there is no oppression.'<sup>635</sup>

Following the approach of Ibn Umar it can be argued that where the fraudulent breach does not cause the insurer any harm he should not exercise his right of avoidance. If the insurer decides to avoid the contract, the question shall arise as to whether the insurer should pay back or retain the premiums. Several Ahadith answer this question by requiring the buyer to return the goods along with the value that he has already consumed:

قَالَ أَبُو هُرَيْرَةَ رَضِيَ اللَّهُ عَنْهُ عَنِ النَّبِيِّ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ لَا تُصَرُّوا الْإِبِلَ وَالْغَنَمَ فَمَنْ ابْتَاعَهَا بَعْدُ فَإِنَّهُ بِخَيْرِ النَّظَرَيْنِ بَعْدَ أَنْ يَحْتَلِبَهَا إِنْ شَاءَ أَمْسَكَ وَإِنْ شَاءَ رَدَّهَا وَصَاعَ تَمْرٍ

*Narrated by Abu Huraira, The Prophet said, 'Don't keep camels and sheep unmilked for a long time, for whoever buys such an animal has the option to milk it and then either to keep it or return it to the owner along with one Sa of dates.'*<sup>636</sup>

According to this Hadith the insurer has to pay the premiums back if he avoids the contract. There a question may arise as to the profit of investment whether it should also be returned. Assume that the buyer of above Hadith sells the milk of the camel and then returns it. In such case, should he pay the profit on the milk to the seller? The Prophet said to return the cost of the milk but did not say anything if he makes profit. In such case it is assumed that the profits need not be returned.<sup>637</sup>

This Islamic remedy is almost similar to that of current English law remedy. The author recommends continuing the application of this remedy in English insurance law. However, the Islamic law requires the insurer to pay the premiums back whereas the English insurance

<sup>635</sup> Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari* الأَجْرِبِ أَوْ الْهَيْمِ أَوْ الْإِبِلِ الْهَيْمِ - بَابُ شِرَاءِ الْإِبِلِ الْهَيْمِ أَوْ الْأَجْرِبِ أَوْ الْهَيْمِ No. 1993, Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari* (Dr. M Muhsin Khan tr) Vol 3 Book 34, 312.

<sup>636</sup> Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari*, بَابُ النَّهْيِ لِلْبَائِعِ أَنْ لَا يَحْفَلَ الْإِبِلَ وَكُلِّ مَحْفَلَةٍ وَكُلِّ مَحْفَلَةٍ وَكُلِّ مَحْفَلَةٍ وَكُلِّ مَحْفَلَةٍ Hadith No. 2041; Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari* (Dr. M Muhsin Khan tr) Vol 3 Book 34, 358.

<sup>637</sup> This conclusion has been derived on the basis of Qiyas.



law allows the insurer to keep the premiums. In such case, the Islamic insurers should incorporate a term stating that he would return the premiums giving up his right as provided by the English insurance law so as to make the policy Shariah compliant.

#### *Reckless nondisclosure or misrepresentation*

It has already been clarified that there is a difference between the seriousness of the breach caused by fraud and recklessness. Since there is a difference in the seriousness of the offence there should be difference in the remedy too. As Allah (SWT) divided the people on the basis of the degree of their act and provided remedy accordingly. As He says

لا يستوى القاعدون من المؤمنين غير أولى الضرر والمجاهدون في سبيل الله بأموالهم وأنفسهم- فضل الله المجاهدين بأموالهم وأنفسهم على القاعدين درجة- وكلا وعد الله الحسنى- وفضل الله المجاهدين على القاعدين أجرا عظيما

*Not equal are those believers remaining [at home] – other than the disabled – and the mujahideen, [who strive and fight] in the cause of Allah with their wealth and their lives. Allah has preferred the mujahideen through their wealth and their lives over those who remain [behind], by degrees. And to both Allah has promised the best [reward]. But Allah has preferred the mujahideen over those who remain [behind] with a great reward.*<sup>638</sup>

The author, therefore, recommends the remedy on the basis of their degree of offence. According to the aforementioned discussion, the intentional i.e. fraudulent nondisclosure or misrepresentation is more serious than the breach done with recklessness. As such, the latter's punishment should be less serious. Accordingly, the insured should be allowed to receive his portion of the profit that is made on his contribution to the pool along with his actual contribution if the policy is avoided by the insurer. Payment of the profit is not recognized in English insurance law due to the operational differences. English insurance law does not prohibit such payment of the profit. Consequently, the insurer should be allowed to include term in the contract stating that the profit shall be paid back in these circumstances.

#### *Negligent nondisclosure or misrepresentation*

The remedy recommended by the Law Commission for negligent nondisclosure or misrepresentation is found to be fair. Consequently, this remedy should be Shariah compliant. However, until the English law is changed in line with the Law Commission's proposals,

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<sup>638</sup> *The Holy Qur'an* 4: 95.

Islamic insurers should incorporate certain terms giving effect to the recommended remedy since the present English law remedy contradicts with Shariah principles by causing injustice as analysed above. Allah (SWT) has ordered saying

إن الله يأمركم أن تؤدوا الامنت إلس أهلها وإذا حكمتم بين الناس أن تحكموا بالعدل،

*Surely Allah commands you to make over trusts to their owners and that when you judge between people you judge with justice.*<sup>639</sup>

The term giving effect to the recommended remedy should not breach the present English insurance law as it allows the insurer to avoid the contract and the insurer will reduce his right of avoidance by stipulating that he should be placed in a position where he should have been had there been no breach.

#### *Innocent nondisclosure or misrepresentation*

Where the insured is innocent, the avoidance of the contract after the peril occurs would be disastrous for him. Further, a person who is unaware of the materiality of certain fact and as such fails to disclose he should not be punished with the same punishment, that the person who intentionally conceals it. As Imam Malik said,

قال مالك رحمه الله الأمر المجتمع عليه عندنا فيمن باع ... حيوانا بالبراءة من أهل الميراث أو غيرهم فقد برئ من كل عيب فيما باع إلا أن يكون علمه فس ذلك عيبا فكتمه فإن كان علم عيبا فكتمه لم تنفعه تبرئته وكان ما باع مردودا عليه

*Malik (ra) said 'The generally agreed upon way of doing things among us regarding a person, whether he is an inheritor or not, who sells an ...animal, without a liability agreement, is that he is not responsible for any defect in what he sold unless he knew about the fault and concealed it. If he knew that there was a fault and concealed it, his declaration that he was free of responsibility does not absolve him, and what he sold is returned to him.'*<sup>640</sup>

The English law should therefore not be applied in Islamic policies. Further, the Law Commission did not propose any remedy where the insured acts reasonably leading to injustice for the insurer as analysed above and as such should not be applied in Islamic policies. The remedy that considers the rights of both parties should be supported by Shariah principles. Abu'l-Husain Muslim b. Hajjaj stated:

<sup>639</sup> ibid 4: 58.

<sup>640</sup> Imam Malik bin Anas, *Al-Muwatta*, (USC Centre for Muslim-Jewish Engagement tr, <<http://www.usc.edu/org/cmje/religious-texts/hadith/muwatta/032-mmt.php>>) Book 31, No. 31.4.4.

Islam expects the buyer and the seller to look upon each other as Muslim brethren or fellow human beings, each trying to go all his way to help and serve the other. If the seller happens to overcharge the buyer, he, instead of feeling proud of his cleverness in doing so, should somehow compensate him for the excessive payment received.<sup>641</sup>

The remedy recommended by the author for English insurance law is found to be fair for both parties and as such should comply with the Islamic rules. Consequently, the Islamic policies can be accommodated in the English legal system if the author's recommended remedy is applied.

Until the author's recommended remedy is applied in the English legal system the Islamic insurer should incorporate certain terms giving effect to the author's recommended remedy so as to make the policy Shariah compliant. Giving effect to the author's recommended remedy should not breach English insurance law since it gives the insurer a choice to avoid the whole contract, whilst the recommended remedy reduces that right of avoiding the whole contract.

### *The Cut-off Period*

According to the above discussion, it is apparent that the cut-off period should be applied to avoid injustice. It is obvious that Islamic law opposes any sorts of injustice. Hence the application of the author's recommended remedy in the English legal system should accommodate the Islamic policies. However, until English insurance law adopts the author's recommended remedy an Islamic insurer should incorporate terms stating that he shall not avoid such contract for negligent or innocent breach after the expiry of 3-year cut off period. The incorporation of such term would not breach current law since the insurer is giving up his right of avoidance given by English insurance law.

## **5.2 Remedy against the Insurer**

### **5.2.1 English Law**

The only remedy against the insurer is avoidance by the insured as stated in section 17 of Marine Insurance Act 1906. In *Banque Financiere de la Cite SA v Westgate Insurance Co*

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<sup>641</sup> Abdul Hamid Siddiqi (tr), *Sahih Muslim* (SH. Muhammad Ashraf, Kashmiri Bazar, Lahore, Pakistan 1973) Vol III, 797.

*Ltd*<sup>642</sup> a syndicate of banks lent substantial sums to a businessman who defaulted on the loans. The banks' main security was a series of credit insurance policies, guaranteeing repayment. The banks' brokers placed the insurance, and the banks were co-insured under the policies. The policies contained a clause excluding liability in the event of fraud. One of the broker's employees, L, misrepresented to the banks leading the banks to advance the loan to the companies. The insurer knew the dishonesty of L but did not disclose this to banks. The banks argued that they would not have advanced the money had the insurer informed the matter. They should be compensated for the losses that had resulted due to the insurer's breach of utmost good faith. Steyn J held that 'the remedies of the insured were not limited to avoiding the contract and reclaiming the premium paid, but extended to a claim for damages'. The Court of Appeal<sup>643</sup> rejected the option of damages on the ground that the duty does not arise from the terms of the contract nor Tort. The House of Lords<sup>644</sup> later approved this decision. Consequently, the remedy for the insured is still 'avoidance'.

#### **5.2.1.1 Critical Analysis of the Current Law**

The remedy is same for both parties, this means that either of them will be benefited from the remedy at the expense of the other. The situation can be better explained by the following example, D insures his house against fire risk. Eleven months after taking policy the house is fully burnt causing the damage of £1m. It is subsequently discovered that the insurer breached his duty to act with utmost good faith. The remedy for the insured is to avoid the policy and get the premiums back. If the insured accepts the remedy he will only receive the premiums that he paid to the insurer and will not get any of the claimed amounts. Consequently, the insurer has nothing to lose for his breach. On the other hand, if the insured breaches his duty, innocently or negligently, the insurer can avoid the contract giving the insured those premiums back. In both of these cases the insurer is benefited by being relieved from the claimed amount and the insured is getting only the premiums back that he paid from his pocket. Further to that, the insurer has obtained the profit from the investment of those premiums for eleven months, whilst the insured has been deprived from utilising that money for eleven months meaning that the insurer has used the money of his client for eleven month for free. Consequently, the remedy is 'unbalanced',<sup>645</sup> unreasonable and 'one sided'.<sup>646</sup>

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<sup>642</sup> [1987] 1 Lloyd's Rep 69.

<sup>643</sup> [1990] 1 Q.B. 665.

<sup>644</sup> [1990] 3 W.L.R. 364.

<sup>645</sup> Peter Macdonald Eggers, Simon Picken, Patrick Foss *Good Faith and Insurance Contracts* (2nd edn, LLP 2004) 441.

The remedy is disastrous where the breach of the insurer's duty causes damage to the insured as happened in *Banque Financiere de la Cite SA v Westgate Insurance Co Ltd*.<sup>647</sup> The Law Commission commented that 'the duty of good faith would only become a truly mutual obligation if it were possible for policyholders to claim damages for losses which result from the insurer's bad faith'.<sup>648</sup> John Birds found the Court of Appeal's reasoning to be 'unsatisfactory'.<sup>649</sup> He pointed out that in other areas of law the courts have been prepared to create new torts.<sup>650</sup> Andre Naidoo and David Oughton argued that the duty of good faith may take effect as an implied term.<sup>651</sup> Peter Macdonald Eggers did not accept that a duty must be classified as contractual, tortious, fiduciary or statutory in order for a breach to give rise to a remedy in damages. He pointed out that misrepresentation may give rise to the remedies of both rescission and damages.<sup>652</sup>

### 5.2.1.2 The Approach of Law Commission

The Law Commission published Issues Paper 6 on the remedy for insurer's breach of good faith. They however focused on the breach of an insurer's post-contractual duty. They recommended the remedy for breach of insurer's duty by refusing claim or delaying payment.<sup>653</sup> Their recommended remedy shall therefore be analysed in Chapter 7 of this thesis.

### 5.2.2 Remedy in Australia

Like the Marine Insurance Act 1906, the Australian Insurance Contracts Act 1984 imposes the duty of disclosure on the insured under sections 21 and 21A but fails to do so against the insurer. The only duty it imposes on the insurer is to act with utmost good faith, which is an

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<sup>646</sup> *Manifest Shipping Co Ltd v Uni-Polaris Shipping Co Ltd; The Star Sea* [2001]UKHL 1; [2001]2 WLR 170, [57] (Lord Hobhouse); *Drake Insurance plc v Provident Insurance plc* [2003] EWCA civ 1834; [2004]1 Lloyd's Rep 268 [83] (Rix LJ).

<sup>647</sup> [1987]1 Lloyd's Rep 69.

<sup>648</sup> Law Commission and Scottish Law Commission *Damages for Late Payment and the Insurer's Duty of Good Faith* (Issues Paper 6, 2010) para 4.23.

<sup>649</sup> John Birds, *Birds' Modern Insurance Law* (8<sup>th</sup> edn, Sweet & Maxwell 2010) 157.

<sup>650</sup> For example, breach of confidence: *Fraser v Thames Television* [1984] QB 44; [1983]2 All ER 101.

<sup>651</sup> A Naidoo & D Oughton, 'The confused post-formation duty of good faith in insurance law: from refinement to fragmentation to elimination?' (2005) JBL 346, 371.

<sup>652</sup> P. Macdonald Eggers, 'Remedies for the failure to observe the utmost good faith' [2003] Lloyd's Maritime and Commercial Law Quarterly 249, 275.

<sup>653</sup> Law Commission and Scottish Law Commission *Damages for Late Payment and the Insurer's Duty of Good Faith* (Issues Paper 6, 2010) para 9.3.

implied term by virtue of section 13 of the 1984 Act.<sup>654</sup> The Act does not define the term ‘utmost good faith’, but both academics and courts agree that the duty of utmost good faith ‘is governed by commercial standards of decency, fairness and reasonableness’.<sup>655</sup> Under this duty the insurer ‘must act in a way that gives due consideration to the legitimate interests of the [insured]’.<sup>656</sup> Hence, ‘dishonesty is not to be considered central to the duty’.<sup>657</sup> The extent of the duty depends ‘on the circumstances of any given case’.<sup>658</sup>

However, unlike the English insurance law, the insurer has to pay damages if he is found liable for breach of that implied term duty of utmost good faith. If any fraudulent breach of the duty by the insurer does not cause any damage to the insured the insurer shall not be liable to compensate him. On the other hand, the insurer shall be allowed to avoid the contract even if the fraudulent breach by the insured does not cause any damage to the insurer. Consequently, the remedy is unfair.

### 5.2.3 Critical Analysis and Recommendation

The Law Commission suggested that ‘there is a need for statutory reform, to provide policyholders with appropriate remedies should an insurer act in bad faith, including a right to claim damages’.<sup>659</sup> They also said that ‘the duty of good faith would only become a truly mutual obligation if it were possible for policyholders to claim damages for losses which result from the insurer’s bad faith’.<sup>660</sup>

It is obvious that the current remedy is unreasonable and must be reformed. There can be several kinds of remedy depending on the nature of the duty, it can be contractual, (if the duty of good faith is adopted as implied term alike in Australia) tortious or regulatory. If it is a contractual or tortious duty the insured shall not receive any remedy where the breach does not cause any damage. Whereas the duty should be wide as it is for the insured on the ground that the insured is a seller of the risk. As a seller of the security the insurer should have the similar duty as suggested by the author and the insured should have similar remedy which is

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<sup>654</sup> The extent of the duty will be discussed further in the next chapter.

<sup>655</sup> Matthew Ellis ‘Utmost good faith: The scope and application of s 13 of the Insurance Contracts Act in the wake of *CGU v AMP*’ (2009)20 ILJ 92, 107.

<sup>656</sup> *ibid* 107.

<sup>657</sup> *ibid* 107.

<sup>658</sup> *ibid* 107.

<sup>659</sup> Law Commission and Scottish Law Commission *Damages for Late Payment and the Insurer’s Duty of Good Faith* (Issues Paper 6, 2010) para 4.3.

<sup>660</sup> *ibid* para 4.23.

based on the nature of the breach. The author recommends two categories of remedies depending on the time when the breach is discovered. If the breach is discovered before peril occurs or if breach is discovered after peril occurs.

***If the breach is discovered before peril occurs -***

Fraudulent breach –

- *If the insurer fraudulently breaches his duty the insured shall be allowed to avoid the contract and the insurer shall repay to the insured the paid premiums and interest at the judgment rate on those premiums from the day of taking policy till the day the premiums are returned. If the breach causes any damage to the insured the insurer shall also pay for that damage.*

Negligent breach –

- *The undisclosed fact or misrepresentation is of such seriousness that a reasonable insured in his position would not have taken the policy with this insurer: the insured shall be allowed to avoid the contract and the insurer shall repay the paid premiums to the insured. Where the breach causes any damage to the insured the insurer shall pay for that damage.*

- *The undisclosed fact or misrepresentation is minor that a reasonable insured in his position would have taken the policy with this insurer: the insured shall not be allowed to avoid it but shall receive 10% discount in his premiums from the day of taking policy. If the breach causes any damage to the insured the insurer shall pay for that damage.*

Innocent breach-

- *The undisclosed fact or misrepresentation is of such seriousness that a reasonable insured in his position would not have taken the policy with this insurer: the insured shall be allowed to avoid the contract.<sup>661</sup> If there is any damage due to the breach the insurer shall pay for that damage.*

- *The undisclosed fact or misrepresentation is minor that a reasonable insured in his position would have taken the policy: the insured shall not be allowed to avoid the contract. If there is any damage due to that breach the insurer shall pay for that damage.*

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<sup>661</sup> The insurer will keep the premiums since he has served the insured for certain period with honesty.

### ***If the breach is discovered after peril occurs***

Fraudulent breach –

- *The insurer shall pay the full claim and repay the paid premiums to the insured. If the breach causes any damage to the insured the insurer shall pay for that damage.*

Negligent breach –

- *The insurer shall pay full claim and repay 50% of paid premiums to the insured.<sup>662</sup> If the breach causes any damage to the insured the insurer also shall pay for that damage.*

Innocent breach –

- *The insurer shall pay full claim and damages, if any, caused by his breach.*

### **5.2.4 The Remedy under Shariah Principles**

It has been clear from the aforementioned Ahadith and Quranic verses that the insurer must disclose every material fact that may affect the decision of the insured. There are several key principles of transaction can be drawn from those texts that neither the buyer nor seller is allowed to hide any material fact nor misrepresent,<sup>663</sup> and if either party does so, the contract becomes voidable.<sup>664</sup> The avoiding party must pay the cost of the consumed part of the goods.<sup>665</sup> Finally, the transaction must be based on justice and mutual understanding,<sup>666</sup> and there must not be any oppression.<sup>667</sup>

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<sup>662</sup> There may be a question: why shall the insurer be required to pay 50% of the paid premiums whilst the insured is getting what he has made the contract for i.e. full claim. A story should be mentioned in reply to this question. George is a vegetarian. He has recently gone to a restaurant where he was served with soup saying that it was vegetable soup. Subsequently he discovered that it was chicken soup but he has already finished it. In such case what is the remedy he should get? He had something that he never wanted to eat but because of the negligence of the restaurant staff. In such case should he not get the money back from the restaurant? If it is logical to get the money back whilst he had the soup and got every benefit from it, then why should the insured not be allowed to get 50% of his paid premiums (along with the claim) from the insurer who negligently misrepresented to him? However, even after reading this example if majority considers that accepting the claim would be sufficient remedy then the law makers can avoid the requirement of paying 50% of premiums back. In such case the remedy for both negligent breach and innocent breach would be same.

<sup>663</sup> See, *Mikhail Masabih*, Kitab -al-Buyu, (trs.) Karim, No. 55, p. 284.

<sup>664</sup> Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari* أو الأَجْرِبَ الإِبْلِ أُلُهَيْمِ أَوِ الأَجْرِبَ الأَجْرِبِ No. 1993, M Muhsin Khan (tr) *Sahih Bukhari* Vol 3 Book 34, 312.

<sup>665</sup> *ibid* محفلة وكل محفلة وكتاب البيوع. باب النهى للبائع أن لا يحفل الإبل والبقر والغنم وكل محفلة Hadith No. 2041; Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari* (Dr. M Muhsin Khan tr) Vol 3 Book 34, 358.

<sup>666</sup> Abdul Hamid Siddiqi (tr), *Sahih Muslim* (SH. Muhammad Ashraf, Kashmiri Bazar, Lahore, Pakistan 1973) Vol III, 792, 795.

<sup>667</sup> A. A. Muslim, *Sahih Muslim*, (USC Centre for Muslim-Jewish Engagement tr, <<http://www.usc.edu/org/cmje/religious-texts/hadith/muslim/032-smt.php>>) Book 32, No. 6248. Accessed 05/07/2013.



The recommended remedy for English law detailed above should satisfy these key factors. However, due to operational differences these remedies cannot be applied in the Islamic policies. Consequently, the author recommends a slightly different remedy for Islamic insurance policies.

***If the breach is discovered before peril occurs***

Fraudulent or reckless breach –

- *The insured shall be allowed to avoid the policy and the insurer shall repay the paid contributions to the insured, i.e. premiums and the profits that he made from the investment of those premiums. If the breach causes any damage to the insured the insurer shall pay for that damage from his pocket not the risk pool.*

Negligent breach –

- *The undisclosed fact or misrepresentation is of such seriousness that a reasonable insured in his position would not have taken the policy with this insurer: the insured shall be allowed to avoid the contract and the insurer shall repay the paid premiums along with 50% of profits made on those premiums to the insured.<sup>668</sup> If the breach causes any damage to the insured the insurer shall pay for that damage from his pocket not the risk pool.<sup>669</sup>*
- *The undisclosed fact or misrepresentation is minor that a reasonable insured in his position would have taken the policy with this insurer: the insured shall not be allowed to avoid the contract but shall receive 10% discount in the premiums from the day of taking policy. Since the discount shall cause injustice to the other participants of the risk pool the insurer shall pay that amount from his pocket to the risk pool.<sup>670</sup> If the breach causes any damage to the insured the insurer shall pay for that damage from his pocket not the risk pool.*

Innocent breach –

- *The undisclosed fact or misrepresentation is such serious that a reasonable insured would not have taken the policy with this insurer: the insured shall be allowed to avoid the contract. Where the breach causes any damage to the insured the insurer shall pay for that damage from his pocket not the risk pool.*

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<sup>668</sup> The reasons for allowing the insured to get 50% of the profit is to honour the hard work of the insurer in investing the money by paying the rest 50% to the pool.

<sup>669</sup> Since the breach is caused by the insurer not the participants of the risk pool.

<sup>670</sup> The participants of the risk pool should not suffer for the negligence of the insurer.

- *The undisclosed fact or misrepresentation is less serious that a reasonable insured would have taken the policy: the insured shall not be allowed to avoid the contract. Where the breach causes any damage to the insured the insurer shall pay for that damage from his pocket not the risk pool.*

These recommended remedies are based on the spirit of prohibition on illegal profit. The Prophet (PBUH) strictly prohibited the concealment of any material fact or misrepresentation. If someone obtains a product by doing these illegal acts then retaining the goods and the profit from that product is also illegal. As such he is bound to return the product along with the profit to the original owner. As Abul-Hussain Muslim said

Islam is most vehement in its condemnation of commercial dishonesty. It denounced, in the strongest possible terms, all sorts of deceitful dealings and illegal profits. It has disallowed all transactions not based upon justice and fairplay. The Holy Prophet (may peace be upon him), while reprimanding the dishonest dealer, said: '*Laisa minna man gashshdna*' (Whosoever deceives us is not one of us).<sup>671</sup>

In explanation of a Quranic verse,<sup>672</sup> he said that 'we are told that the lawful profit which has God's blessings is the one that we are able to make through perfectly honest dealings with others'.<sup>673</sup>

The following story said by Prophet Muhammad (PBUH) shows how a person should deal with the profit made on other's asset:

عَنْ نَافِعٍ عَنِ ابْنِ عُمَرَ رَضِيَ اللَّهُ عَنْهُمَا عَنِ النَّبِيِّ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ قَالَ خَرَجَ ثَلَاثَةٌ نَفَرٍ يَمْشُونَ فَأَصَابَهُمُ الْمَطَرُ فَدَخَلُوا فِي غَارٍ فِي جَبَلٍ فَانْحَطَّتْ عَلَيْهِمْ صَخْرَةٌ قَالَ فَقَالَ بَعْضُهُمْ لِبَعْضٍ ادْعُوا اللَّهَ بِأَفْضَلِ عَمَلٍ عَمِلْتُمُوهُ ... وَقَالَ الْآخَرُ اللَّهُمَّ إِنْ كُنْتَ تَعْلَمُ أَنَّنِي اسْتَأْجَرْتُ أُجِيرًا بِفَرْقٍ مِنْ دُرَّةٍ فَأَعْطَيْتُهُ وَأَبَى ذَلِكَ أَنْ يَأْخُذَ فَعَمَدْتُ إِلَى ذَلِكَ الْفَرْقِ فَزَرَعْتُهُ حَتَّى اسْتَرْبَتْ مِنْهُ بَقَرًا وَرَاعِيهَا ثُمَّ جَاءَ فَقَالَ يَا عَبْدَ اللَّهِ أَعْطِنِي حَقَّ فَقُلْتُ انْطَلِقْ إِلَى تِلْكَ الْبَقَرِ وَرَاعِيهَا فَإِنَّهَا لَكَ فَقَالَ أَنَسْتَهْزِي بِسِ قَالِ فَقُلْتُ مَا اسْتَهْزِي بِكَ وَلَكِنَّهَا لَكَ اللَّهُمَّ إِنْ كُنْتَ تَعْلَمُ أَنَّنِي فَعَلْتُ ذَلِكَ ابْتِغَاءً وَجْهَكَ فَأَفْرُجْ عَنَّا فَكُتِفَ عَنْهُمْ

*The Prophet said, 'while three persons were walking, rain began to fall and they had to enter a cave in a mountain. A big rock rolled over and blocked the mouth of the cave. They said to*

<sup>671</sup> Abdul Hamid Siddiqi (tr), *Sahih Muslim* (SH. Muhammad Ashraf, Kashmiri Bazar, Lahore, Pakistan 1973) Vol III, 791.

<sup>672</sup> *The Holy Quran* 11:85-86.

<sup>673</sup> Abdul Hamid Siddiqi (tr), *Sahih Muslim* (SH. Muhammad Ashraf, Kashmiri Bazar, Lahore, Pakistan 1973) Vol III, 792.

*each other, 'Invoke Allah with the best deed you have performed (so Allah might remove the rock)'...Then the third man said, 'O Allah! No doubt You know that once I employed a worker for one Faraq (three Sa's) of millet, and when I wanted to pay him, he refused to take it, so I sowed it and from its yield I bought cows and a shepherd. After a time that man came and demanded his money. I said to him: Go to those cows and the shepherd and take them for they are for you. He asked me whether I was joking with him. I told him that I was not joking with him, and all that belonged to him. O Allah! If You regard that I did it sincerely for Your sake, then please remove the rock.' So, the rock was removed completely from the mouth of the cave'.<sup>674</sup>*

It is apparent that the recommended remedies for Islamic policies are slightly different from that of for English insurance policies. Consequently, the insurer has to incorporate certain terms so as to give effect to the author's recommended remedy. Incorporation of such terms shall not breach English law. For example, under English law, under the author's recommendation, the insurer is required to pay interest. The term should stipulate that the insured will give up his right of getting interest from the insurer and the insurer shall promise that he will pay back profits. However, until the English law is reformed giving effect to the author's recommended remedy, the Islamic insurer should incorporate adequate terms to apply the author's recommended remedy for Islamic policies.

### ***If the breach is discovered after peril occurs***

Fraudulent or reckless breach –

*- The insurer shall pay the full claim, repay the paid premiums and pay the profit made on those premiums.<sup>675</sup> Since the paying of the premiums and profits back to the insured shall cause injustice to other participants of the risk pool the insurer shall pay those amounts from his pocket.<sup>676</sup> The insurer shall also pay the damage (if any) caused by his fraudulent breach from his pocket not the risk pool.*

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<sup>674</sup> Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari*, Kitab al-Buyu, Book 34, Bab, 98, No. 2255.

<sup>675</sup> Since the insurer has fraudulently taken the policy he should not be allowed to keep any profit on the paid premiums.

<sup>676</sup> The participants to the risk pool should not be punished for the fraudulent act of the insurer.

Negligent breach –

- *The insurer shall pay the claim. He shall also repay to the insured 50% of the paid premiums from his pocket.<sup>677</sup> If there is any damage to the insured due to the breach the insurer shall pay for that damage from his pocket.*

Innocent breach –

- *The insurer shall pay the full claim. If there is any damage due to the breach the insurer shall pay for that damage for his pocket.*

The difference between the author's recommended remedy for English insurance policies and Islamic policies can also be found in this part of the law. The difference is caused due to the operational differences between these two types of insurance policies. In these circumstances the Islamic insurer should take the similar measures as suggested for the previous case.

### **5.3 Conclusion**

The current English insurance law has imposed the 'draconian' remedy for breach of the unreasonable duty. The remedy is unjustifiable because it is same for every category of breach. Following the Law Commission's recommendation the Consumer Insurance (Disclosure and Representations) Bill, therefore, recommended different kinds of remedy for different categories of breach. The Bill, however, did not recommend any remedy where the insured breaches his duty by making an honest mistake meaning that the insurer could suffer significant losses if it is a serious breach. Consequently, neither the current remedy nor the remedy recommended by the Bill can accommodate Shariah principles. However, the remedy recommended by the Bill is fair in certain cases. The author, therefore, suggests applying the fair parts of the remedy and proposed different remedy for other parts of the breach. Yet the recommended remedy cannot fully comply with Shariah principles due to the operational differences between English and Islamic insurance policies. Islamic insurers, therefore, will have to incorporate certain terms to make their policies Shariah compliant.

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<sup>677</sup> In this case the insurer has induced the insured to enter into the contract by keeping some defects undisclosed. According to the Hdith mentioned above the policy should be void, but this remedy shall cause serious injustice to the insured which is strictly prohibited in Islamic. In such case the insured should get the claim and also 50% of the premiums back since the insurer has taken them illegally. However, since the insured has done hard work in the investment of those premiums and eventually paying the claim the insurer should be allowed to keep 50% of those premiums in the risk pool and full profits from the investment of the full paid premiums. However, if majority considers that getting 50% of the premiums back would unjustly enrich the insured the insurers can avoid paying them.

The cut-off period in life insurance has been termed as ‘arbitrary’ by the Law Commission in the draft Bill, although they proposed the cut off period in two consultation papers finding it necessary to establish justice. The author has also found such a provision necessary and as such recommends its application in the English legal system. This cut-off period should also be Shariah compliant as it establishes fairness.

Since the duty of insurer as a seller of security has never been recognised, any remedy for breach of that duty has also never been applied. However, the current law imposes a mere duty on the insurer to disclose the fact that he knows. The law allows the insured to avoid the contract *ab initio* for breach of that duty. However, the remedy of avoidance operates as a punishment for the insured. Consequently, no insured has ever claimed this unjustifiable remedy. The Law Commission did not propose any remedy for breach of the insurer’s duty. The author recommends the remedy for breach of both the duty as a buyer of the risk and seller of the security. The author also recommends different remedies when a breach of the duty is discovered before the peril occurs to when a breach is discovered after the peril occurs. This innovative approach should establish fair balance between the interests of the insured and insurer. These fairer remedies should make the application of Islamic policies easier. However, due to the operational differences the recommended remedies cannot be directly applied. The author, therefore, recommends certain terms that should be incorporated to make the policies Shariah compliant.

## Chapter 6 – Continuing Duty of Utmost Good Faith

### 6.0 Introduction

In *Manifest Shipping Co Ltd v Uni Polaris Shipping Co Ltd*<sup>678</sup> Lord Hobhouse confirmed that utmost good faith is ‘a principle of fair dealing which does not come to an end when the contract has been made’.<sup>679</sup> Accordingly, both the insured and insurer must observe the duty of utmost good faith during the policy, otherwise the innocent party may avoid the contract *ab initio* by virtue of section 17 of the Marine Insurance Act 1906. Avoidance *ab initio* is seen to be the highest level of punishment in an insurance contract, particularly at the claim stage.<sup>680</sup> The highest level of punishment should be imposed for breach of highest level of duty.<sup>681</sup> As such the duty to observe utmost good faith seems to be the highest level of duty in an insurance contract. This duty demands the highest level of certainty,<sup>682</sup> reasonableness and proportionality. It is very unfortunate that in English law the highest level of duty has received the highest level of uncertainty, unreasonableness and disproportionality.<sup>683</sup> Such uncertainty, unreasonableness or disproportionality in the duty is not allowed under Shairah principles. Consequently, the application of Islamic insurance policies is hindered by the contradiction between the English insurance law and Shariah principles. The Law Commission have taken steps to reform English insurance law to make it certain, reasonable and fair. Hence, the application of the Islamic policies will be easier if a reasonable and fair duty is applied. This chapter therefore considers how to make the post-contract duties of both the insured and insurer fair and reasonable.

The courts and academics have both stated that the post-contract duty of utmost good faith should not be applied in its full rigour throughout the duration of the contract, but rather ‘at a

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<sup>678</sup> [2001] UKHL 1, [2001]2 WLR 170.

<sup>679</sup> *Manifest Shipping Co Ltd v Uni Polaris Shipping Co Ltd (The Star Sea)* [2001] UKHL 1, [2001]2 WLR 170, [48]. See also *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd; The Star Sea* [1997]1 Lloyd’s Rep 360; *New Hampshire Insurance Company v MGN Ltd* [1997] LRLR 24, 48 (Potter J), 61 (Staughton LJ). *Agnew v Liansforskakringsbolagens AB* [2001] AC 223, 241 (Lord Woolf MR).

<sup>680</sup> Staughton LJ said in *Kausar v Eagle Star Insurance Co Ltd* [1997] CLC 129, 132-133 ‘Avoidance for non-disclosure is a drastic remedy. It enables the insurer to disclaim liability after, and not before, he has discovered that the risk turns out to be a bad one; it leaves the insured without the protection which he thought he had contracted and paid for...there should be some restraint in the operation of the doctrine.’

<sup>681</sup> See, *K/S Merc-Scandia XXXXII v Certain Lloyd’s Underwriters (The Mercandian Continent)* [2001] EWCA Civ 1275, [2001] Lloyd’s Rep. I.R 802 [26] (Longmore LJ).

<sup>682</sup> See, A Naidoo & D Oughton, ‘The confused post-formation duty of good faith in insurance law: from refinement to fragmentation to elimination?’ (2005) *Journal of Business Law* 346, 349.

<sup>683</sup> Lord Clyde commented in *Manifest Shipping Co Ltd v Uni Polaris Shipping Co Ltd (The Star Sea)* [2001] UKHL 1, [2001]2 WLR 170 [5] ‘What has caused me greater difficulty is the broad provision in s 17 which appears to be unlimited in its scope.’

level appropriate to the moment'.<sup>684</sup> They take the view that the post-contract duty varies according to the various stages of the relationship of the parties.<sup>685</sup> There are three stages to an insurance contract,<sup>686</sup> before entering into the contract, during the contract and when a claim has been made. The renewal of the contract may be viewed as a separate, fourth, stage or a return to the first stage. However, in law, the pre-contract duty should be applied at this renewal stage and it has been discussed in Chapter 4. Consequently, the duties at the second and third stages of the contract will be discussed in this chapter.

## 6.1 Duty of the Insured at the Second Stage of the Contract - During the Policy

### 6.1.1 English Insurance Law

There is a weak argument saying that the duty does not exist during the policy. The argument is based on the assumption that the Act was not intended to impose such a draconian remedy<sup>687</sup> in an unreasonable manner. Imposition of this remedy during the policy for not disclosing an alteration of the risk is harsh.<sup>688</sup> As such section 17 should be deemed to be a preamble of section 18.<sup>689</sup>

On the other hand, the courts have approved the argument that the duty exists during the policy,<sup>690</sup> but remains unsure about its nature. The argument is that if section 17 is deemed to

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<sup>684</sup> Malcolm Clarke, *The Law of Insurance Contracts* (3rd edn. Informa, 1997), para.27-1A. (Approved in *The Star Sea* [1997] 1 Lloyd's Rep. 360, 369 (Leggatt LJ), cited as it was in the 2nd ed. at p 708)

<sup>685</sup> In *Manifest Shipping Co Ltd v Uni Polaris Shipping Co Ltd (The Star Sea)* [2001] UKHL 1, [2001]2 WLR 170 [7] (Lord Clyde). See also M A Clarke, *The Law of Insurance Contracts*, (4th edn, Informa 2002), paras 27-1A - 27-1A2, Peter Macdonald Eggers, Simon Picken and Patrick Foss *Good Faith and Insurance Contracts* (2nd edn, LLP 2004) 50.

<sup>686</sup> See, Callan O'Neill 'A Pot of Gold? The Unfinished Story of Utmost Good Faith and the Insurance Contracts Act' (2008) 19 Insurance Law Journal 245, 249.

<sup>687</sup> See, *Manifest Shipping Co Ltd v Uni Polaris Shipping Co Ltd (The Star Sea)* [2001] UKHL 1, [2001]2 WLR 170 [109] (Lord Scott).

<sup>688</sup> Staughton, LJ said in *Kausar v Eagle Star Insurance Co Ltd* [1997] CLC 129, 132-133 'Avoidance for non-disclosure is a drastic remedy. It enables the insurer to disclaim liability after, and not before, he has discovered that the risk turns out to be a bad one; it leaves the insured without the protection which he thought he had contracted and paid for...there should be some restraint in the operation of the doctrine.'

<sup>689</sup> See, John Birds *Birds' Modern Insurance Law* (7th edn, Sweet & Maxwell 2007) 136. See also Andre Naidoo, David Oughton 'The confused post-formation duty of good faith in insurance law: from refinement to fragmentation to elimination?' [2005] JBL 346, 347-348; Christopher Butcher 'Good faith in insurance law: a redundant concept?' [2008] Journal of Business Law 375, 382.

<sup>690</sup> In *Manifest Shipping Co Ltd v Uni Polaris Shipping Co Ltd (The Star Sea)* [2001] UKHL 1, [2001] 2 WLR 170 [48], Lord Hobhouse confirmed that 'the utmost good faith is a principle of fair dealing which does not come to an end when the contract has been made'. Lord Clyde said at para 7 'even after the contract is entered into the relationship between the parties should in any event be coloured by considerations of good faith.' See also, *Black King Shipping v Massie (The Litsion Pride)* [1985] 1 Lloyd's Rep. 437 represents the highpoint of the perceived post-formation duty. *The Mercandian Continent* [2001] EWCA Civ 1275; [2001] 2 Lloyd's Rep. 563 [31] (Longmore LJ); *Overseas Commodities Ltd v Style* [1958] 1 Lloyd's Rep 546, 559; *Liberian Insurance Agency v Mosse* [1977]2 Lloyd's Rep 560; *Orakpo v Barclays Insurance Services* [1995] LRLR 443; *New*

be a preamble, then it becomes superfluous and unnecessary meaning that the Act would not have included it. The inclusion of this section proves that the Act intended to give effect to it, which eventually imposes the duty throughout the policy.<sup>691</sup> Lord Hobhouse quoted the statement of McNair J with approval that the obligation of good faith rests on the insured ‘throughout the currency of the policy’.<sup>692</sup> Subsequently, in *K/S Merc-Scandia XXXXII v Certain Lloyd’s Underwriters (The Mercandian Continent)*,<sup>693</sup> the Court of Appeal confirmed the continuance of the duty during the policy. While it becomes clear that the duty exists during the policy, the courts struggle to identify the nature of the duty. The courts simply say that the nature and degree of the duty vary according to the necessity of maintaining the good faith. It seems that the courts intend to leave the issue to common sense instead of making specific rules. Lord Clyde said ‘the idea of good faith in the context of insurance contracts reflects the degrees of openness required of the parties in the various stages of their relationship. It is not an absolute. The substance of the obligation which is entailed can vary according to the context in which the matter comes to be judged’.<sup>694</sup>

Although the matter is left to common sense, no court has yet successfully figured out the actual duty of utmost good faith during the policy. Conceding the difficulty of the task, Lord Hobhouse said in the leading case *Manifest Shipping Co Ltd v Uni Polaris Shipping Co Ltd (The Star Sea)*,

In the pre-contract situation it is possible to provide criteria for deciding what information should be disclosed and what need not be...But when it comes to post-contract disclosure the criterion becomes more elusive: to what does the information have to be material? Some instructive responses have been given. Where the contract is being varied, facts must be disclosed which are material to the additional risk being accepted by the variation. It is not necessary to disclose facts occurring, or discovered, since the original risk was accepted material to the acceptance and rating of that risk. Logic would suggest that such new information might be valuable to the underwriter. It might affect how hard a bargain he would drive in exchange for agreeing to the

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*Hampshire Insurance Company v MGN Limited* [1997] LRLR 24, 48 (Potter LJ), 61 (Staughton LJ); *Agnew v Liansforskakringsbolagens AB* [2001] AC 223, 241 (Lord Woolf MR).

<sup>691</sup> See, John Birds, *Birds’ Modern Insurance Law* (8th edn, Sweet & Maxwell 2010) 142.

<sup>692</sup> *Overseas Commodities v Style* [1958] 1 Lloyd’s Rep. 546, 549.

<sup>693</sup> EWCA Civ 1275, [2001] Lloyd’s Rep. I.R 802 [35] (Longmore LJ).

<sup>694</sup> In *Manifest Shipping Co Ltd v Uni Polaris Shipping Co Ltd (The Star Sea)* [2001] UKHL 1, [2001]2 WLR 170 [7]. See also M A Clarke, *The Law of Insurance Contracts*, (4th edn, Informa 2002), paras 27-1A - 27-1A2, Peter Macdonald Eggers, Simon Picken and Patrick Foss *Good Faith and Insurance Contracts* (2nd edn, LLP 2004) 50.



variation; it might be relevant to his reinsurance decisions. But it need not be disclosed.<sup>695</sup>

It becomes apparent from the approach of the courts in different cases that there is no effective duty, save the duty of not being fraudulent, during the second stage of the policy. John Birds therefore commented that ‘the precise nature and content of the post-contractual duty post was not spelt out further’.<sup>696</sup> Such ambiguous nature of duty causes difficulty ‘as to when the remedy of avoidance *ab initio* will be available’.<sup>697</sup> Considering the cases *the Star Sea*,<sup>698</sup> *K/S Merc-Scandia XXXXII v Certain Lloyd’s Underwriters (The Mercandian Continent)*,<sup>699</sup> and *Agapitos v Agnew (The Aegeon)*,<sup>700</sup> he commented, that these ‘three decisions, taken together, cast doubt on the right to avoid the contract *ab initio* for breach of a post contractual duty of utmost good faith’.<sup>701</sup> Considering this uncertainty he suggested that the insurers ‘consider their position by focusing on their contractual remedies’.<sup>702</sup> The insurers included such terms in the cases like *Shaw v Robberds*<sup>703</sup>, *Pim v Reid*<sup>704</sup> or *Kausar v Eagle Star Insurance Co. Ltd.*<sup>705</sup> In none of the cases the court strictly followed the terms of the contracts. The courts interpreted these terms considering the common law position of alteration of risk. As Savile LJ said in *Kausar v Eagle Star Insurance Co. Ltd.*,

In my judgment all that this Condition does is to state the position as it would exist anyway as a matter of common law, namely that without the further agreement of the insurer, there would be no cover where the circumstances had so changed that it could properly be said by the insurers that the new situation was something which, on the true construction of the policy, they had not agreed to cover.<sup>706</sup>

It is interesting to note that the courts are mixing up the duty imposed by the increase of risk clause during the policy and the alteration of risk. These two issues govern two different parts of a contract. For illustration,

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<sup>695</sup> Ibid [54]. See also, *Bank of Nova Scotia v. Hellenic Mutual War Risks Association (Bermuda) Ltd (The GOOD LUCK)* [1988] 1 Lloyd’s Rep 514, 545 (Hobhouse J), His decision related to utmost good faith was not overruled; *Pim v Reid* (1843) 6 Manning and Granger 1 134 E.R. 784, 793 (Tindal CJ).

<sup>696</sup> See, John Birds, *Birds’ Modern Insurance Law* (8th edn, Sweet & Maxwell 2010) 143.

<sup>697</sup> See, *ibid* 143.

<sup>698</sup> *Manifest Shipping Co Ltd v Uni Polaris Shipping Co Ltd (The Star Sea)* [2001] UKHL 1, [2001]2 WLR 170.

<sup>699</sup> [2001] EWCA Civ 1275, [2001] Lloyd’s Rep. I.R. 802.

<sup>700</sup> [2002] EWCA Civ 247, [2002] Lloyd’s Rep. I.R. 573.

<sup>701</sup> See, John Birds, *Birds’ Modern Insurance Law* (8th edn, Sweet & Maxwell 2010) 143.

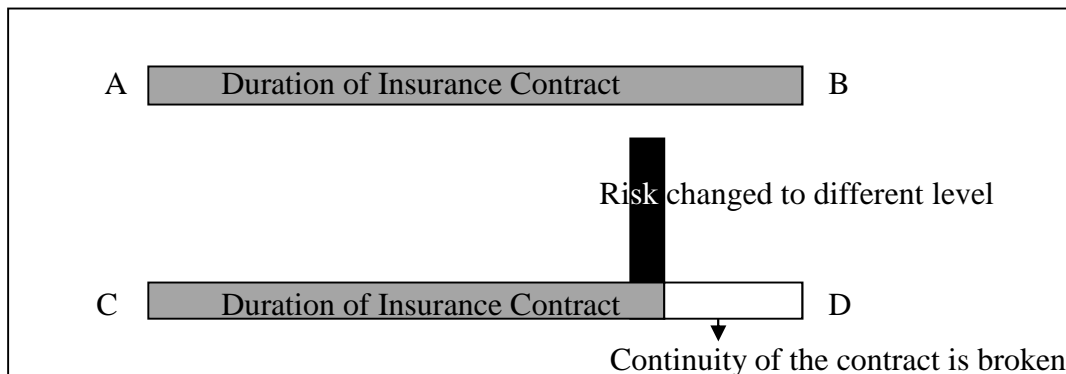
<sup>702</sup> See, *ibid* 143.

<sup>703</sup> (1837) 6 Adolphus and Ellis 75, 112 E.R. 29.

<sup>704</sup> (1843)6 Man. & G. 1, 134 E.R. 784.

<sup>705</sup> [1997] C.L.C. 129,

<sup>706</sup> *ibid* 131



In this picture, the duration of the first contract is from the time A to B. The increase of risk clause should effectively be applied in this contract since the nature of the risk is still in the category that has been originally understood by the parties. The duration of the second contract is from the time C to D. However, the risk in the second contract has changed its nature and as such the common law, as pronounced by Saville LJ,<sup>707</sup> says that after the date of the alteration of risk the basis of the contract is changed by that new risk and as such the insurer is no longer liable after the day of alteration of risk. Hence, it can be said that the continuity of the contract is broken once the risk is substantially altered. Once the basis of the contract is broken no continuing duty can be applied. Consequently, alteration of risk is a separate to the duty imposed during the policy period. Therefore, the increase of risk affecting the duty of 'utmost good faith' is the issue of this chapter not the alteration of risk.

It is apparent from the above discussion that an insured may have a duty during the policy, through the requirement of 'utmost good faith' under section 17 or through contractual terms. It is identified by John Birds that these terms impose 'a duty of disclosure analogous to that imposed by virtue of the principle of utmost good faith'.<sup>708</sup> Consequently, he referred to cases including *Pim v Reid*,<sup>709</sup> within the section 'The Continuing Duty of Utmost Good Faith' in spite of the fact that the rule of utmost good faith was not the basis of those courts' decision. It becomes apparent from the decision of the court in *Manifest Shipping Co Ltd v Uni Polaris*

<sup>707</sup> *Kausar v Eagle Star Insurance Co. Ltd.* [1997] C.L.C. 129, 131 (Saville LJ).

<sup>708</sup> John Birds, *Birds' Modern Insurance Law* (8<sup>th</sup> edn, Sweet & Maxwell 2010) 144.

<sup>709</sup> (1843)6 Man. & G. 1, 134 E.R. 784.

*Shipping Co Ltd (The Star Sea)*,<sup>710</sup> that the duty of utmost good faith does not require the insured to disclose any fact that increases the risk. The common law also imposes a similar rule.<sup>711</sup> The courts interpret the change of risk clauses following the common law rule. Consequently, the insured is not required to disclose the facts that increase the risk under any of these rules. Thus, any circumstance that is negligently created by the insured and that increases the risk of peril causes neither a breach of an increase of risk clause nor the requirement of utmost good faith. For example, in *Pim v Reid*,<sup>712</sup> the plaintiff insured his premises where he carried on the business of a paper-maker. Subsequently, he changed trades and caused a large quantity of cotton waste to be brought on to the premises. It appeared that the insurance offices generally declined to insure premises where such cotton waste was kept or used. Nevertheless, neither the change of trade nor the non-disclosure by the insured was held to have breached the increase of risk clause. If the decision were taken under the rule of utmost good faith, following the decision in *The Star Sea*,<sup>713</sup> it can be said that, the result would not have changed. However, this chapter is only considering the issue of utmost good faith.

### 6.1.2 Critical Analysis of English Insurance Law

The analysis should start with a proper understanding of the term 'utmost good faith'. Prior to the Marine Insurance Act 1906, Willes J used the term 'perfect good faith',<sup>714</sup> whilst Cockburn CJ termed it as 'full and perfect faith'.<sup>715</sup> Lord Hobhouse explained the term used by the Act as 'the most extensive, rather than the greatest, good faith'.<sup>716</sup> Steyn J said that the term 'utmost good faith' imposes reciprocal duty to act with a positive mind.<sup>717</sup> In whatever manner the term is explained,<sup>718</sup> the purpose of using the term is to make sure that the parties

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<sup>710</sup> [2001] UKHL 1, [2001]2 WLR 170.

<sup>711</sup> See, John Birds, *Birds' Modern Insurance Law* (8th edn, Sweet & Maxwell 2010) 142.

<sup>712</sup> (1843)6 Man. & G. 1, 134 E.R. 784.

<sup>713</sup> [2001] UKHL 1, [2001]2 WLR 170.

<sup>714</sup> In *Britton v Royal Insurance Co* (1866) 4 F & F 905, 176 ER 843

<sup>715</sup> *Bates v Hewitt* (1867) LR 2 QB 595, 607.

<sup>716</sup> *Manifest Shipping Co Ltd v Uni Polaris Shipping Co Ltd (The Star Sea)* [2001] UKHL 1, [2001]2 WLR 170, [44].

<sup>717</sup> *Banque Financiere de la Cite v Westgate Insurance Co Ltd*, [1987]2 WLR 1300, 1328. Although the remedy of this court was overruled by the Court of Appeal, the duty explained by this court was reiterated by the later court. See, for instance [1990] 1 Q.B 665, 770-771. The decision in *Drake Insurance Plc v Provident Insurance Plc* [2003] EWCA Civ 1834 carries the similar approach.

<sup>718</sup> See Peter Macdonald Eggers, Simon Picken and Patrick Foss *Good Faith and Insurance Contracts* (2nd edn, LLP 2004) 6; M A Clarke, *The Law of Insurance Contracts*, (4th edn, informa 2002) para 19-5A3; Matthew Ellis 'Utmost good faith: The scope and application of s 13 of the Insurance Contracts Act in the wake of *CGU v AMP*' (2009)20 ILJ 92, 103; C O'Neill, 'A pot of gold? The unfinished story of utmost good faith and the Insurance Contracts Act' (2008) 19 ILJ 245; *Gutteridge v Commonwealth of Australia* Unreported, Qld SC, 25 June 1993, BC9302579 (Ambrose J)

in an insurance contract act with full honesty<sup>719</sup> and mutual understanding<sup>720</sup>, considering both of their interests and refrain from acts that may hamper the other's interest.<sup>721</sup> The Law Commission commented that the term 'utmost' stretched the parties' mutual duties beyond reasonable honesty and integrity.<sup>722</sup> Ambrose J stated 'Acting with "utmost good faith" must involve more than merely acting honestly; otherwise, no effect is given to the word "utmost"'.<sup>723</sup> In the High Court of Australia, with reference to the judgment of Stephen J in *Distillers Co (Bio-Chemicals) (Aust) Pty Ltd v Ajax Insurance Co Ltd*,<sup>724</sup> Gleeson CJ and Crennan J stated that,<sup>725</sup>

[U]tmost good faith may require an insurer to act with due regard to the legitimate interests of an insured, as well as to its own interests. The classic example of an insured's obligation of utmost good faith is a requirement of full disclosure to an insurer, that is to say, a requirement to pay regard to the legitimate interests of the insurer.

According to the above interpretation of the term 'utmost good faith' it is apparent that the insured should have some positive duties at the second stage of the contract. The nature of these positive duties can be ascertained using the following facts of the cases:

In *J.C. Thompson v Equity Fire Insurance Company*,<sup>726</sup> the insured took a policy on his building against fire risk. His assistant Post and his family occupied the upper part of the building as a dwelling-house. Post procured a petrol stove for cooking purposes. He used it for a short time and then put it by with the petrol which happened to be in it. Subsequently,

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<sup>719</sup> See, *Vermeulen v SMIU* (1987) 4 ANZ Ins Cas 60-812 at 70,987; *Kelly v New Zealand Insurance Co Ltd* (1993) 7 ANZ Ins Cas 61-197; BC9301461; *CIC Insurance Ltd v Barwon Region Water Authority* (1999) 10 ANZ Ins Cas 61-425; BC9805758.

<sup>720</sup> See Peter Macdonald Eggers, Simon Picken and Patrick Foss *Good Faith and Insurance Contracts* (2nd edn, LLP 2004) 231; *Barclay Holdings (Aust) Pty Ltd v British National Insurance Co Ltd* (1987) 4 ANZ Ins Cas 60-770; 8 NSWLR 514; In the eye of Matthew Ellis the duty is based on trust. He said 'The insurer must trust that the insured has provided complete and accurate information about the nature of the risk insured while the insured must trust the insurer to provide the protection promised under the policy if and when it is required. This special relationship of trust gives rise to a duty at common law that compels each party to an insurance contract to act towards the other with utmost good faith.' in 'Utmost good faith: The scope and application of s 13 of the Insurance Contracts Act in the wake of *CGU v AMP*' (2009)20 ILJ 92, 92; see also T Scottford, 'The Insurer's Duty of Utmost Good Faith, Implications for Australian Insurers' (1988) 2 ILJ 82, 82-83.

<sup>721</sup> See, Fred Hawke 'Utmost Good Faith - What Does it Really Mean?' (1994) 6 ILJ 91; Professor Steven J Burton 'Breach of Contract and the Common Law Duty to Perform in Good Faith' (1980) 94 Harv LR 369.

<sup>722</sup> Law Commission and Scottish Law Commission *Damages for Late Payment and the Insurer's Duty of Good Faith* (Issues Paper 6, 2010) para, 4.10.

<sup>723</sup> *Gutteridge v Commonwealth of Australia* Unreported, Qld SC, 25 June 1993, BC9302579.

<sup>724</sup> (1973) 2 ALR 321.

<sup>725</sup> *CGU Insurance Ltd v AMP Financial Planning Pty Ltd* (2007) 235 CLR 1; 237 ALR 420; 81 ALJR 1551; [2007] HCA 36; BC200707214, 15.

<sup>726</sup> [1910] A.C. 592.

fire broke out because of this petrol stove. An appeal was made to Privy Council by the insured from the decree of the Supreme Court of Canada. The question for the Privy Council was whether such storage breaches the statutory condition protecting the insurer from liability ‘for loss or damage occurring while [petrol] is stored or kept in the building insured’. These facts could be viewed as an English case with an increase of risk clause included providing that the insurer would not be liable if the insured increases the risk by storing petrol. According to the current law, the insurer should not get any remedy under section 17 whereas the above definition of ‘utmost good faith’ appears to make the insured liable for failing to fulfill his reciprocal duty towards the insurer by being negligent through storing petrol in the premises.

In *Beauchamp v National Mutual indemnity Insurance Co*,<sup>727</sup> a builder who had not previously undertaken any demolition work took out a policy of insurance to cover the demolition of a mill. He was asked in the proposal form ‘are there any explosives used?’ He answered ‘no’, but subsequently used explosive to demolish the mill. The court decided the case on the basis of the policy wording and warranty. The author’s argument is that such a negligent act disregarding the legitimate interest of the insurer should also breach the duty of utmost good faith.

Similarly in *Shaw v Robberds*,<sup>728</sup> the plaintiff insured premises against fire where he used to dry corn. On one occasion he allowed the owner of some bark to dry it in the kiln and this occasioned fire. The insured knew that drying bark carried more risk of fire than that of the corn. If the duty of ‘utmost of good faith’ were applied in the way interpreted above, the insured should have been liable for not refraining from such an action considering ‘the legitimate interests of the insurer’. Consequently, it is argued that the courts, under the current English law, are not interested in applying the duty of ‘utmost good faith’ in its full rigour. There might be two reasons for taking such approach.

The court might be afraid of the drastic effects of the remedy which may cause unfair result for the insured.<sup>729</sup> The fear has made the courts confused as to whether the duty works as an

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<sup>727</sup> [1937]3 All E.R. 19.

<sup>728</sup> (1837) 6 Adolphus and Ellis 75, 112 E.R. 29.

<sup>729</sup> see *Kausar v Eagle Star Insurance Co Ltd* [1997] CLC 129, 132-133 (Staughton LJ); *Drake Insurance Plc v Provident Insurance Plc* [2004] Q.B. 601 [177] (Pill LJ)

implied term or rule of law. In *Litsion Pride*,<sup>730</sup> Hirst J held<sup>731</sup> that ‘the duty not to make fraudulent claims and not to make claims in breach of the duty of utmost good faith is an implied term of the policy’.<sup>732</sup> This approach has been taken to make the remedy flexible as opposed to the avoidance of the policy *ab initio*. It is argued that ‘the duty is mutually owed by the assured and the insurer, so that both parties may be said to agree to the obligations imposed by the implied term’.<sup>733</sup> In *The Good Luck*, Hobhouse J. adopted the similar view that the duty of utmost good faith could arise after the formation of the contract by virtue of an implied term.<sup>734</sup>

The theory of implied terms has been disapproved by subsequent cases on the ground that the continuing duty of disclosure is considered alongside the pre-contract duty and as such a post-formation duty must be based on the same rule of law. Further, ‘at the time of non-disclosure, there is no contract upon which the duty can be said to be based’,<sup>735</sup> and as such the latter has been based on rule of law. In *Banque Financière de la Cité SA v Westgate Insurance Co*,<sup>736</sup> it was argued on the basis of the assumption of implied term that a right to damages could arise from the breach of the duty of utmost good faith. Rejecting the argument the Court of Appeal held that the remedy is only avoidance under section 17. In *The Star Sea*,<sup>737</sup> counsel from both parties accepted that the post-formation duty of utmost good faith was derived from section 17 allowing the party to avoid the contract *ab initio*.<sup>738</sup> Lord Hobhouse held, firmly disapproving the view of Hirst J, that ‘the duty is a matter of the

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<sup>730</sup> *Black King Shipping Corporation and Wayang (Panama) S.A. v Mark Randal Massie (The ‘Litsion Pride’)* [1985] 1 Lloyd’s Rep. 437

<sup>731</sup> *ibid* 518-9.

<sup>732</sup> This is similar to S. 13 of Insurance contracts Act 1984 of Australia, which makes the duty of utmost good faith an implied term of the contract.

<sup>733</sup> A Naidoo & D Oughton, ‘The confused post-formation duty of good faith in insurance law: from refinement to fragmentation to elimination?’ (2005) *Journal of Business Law* 346, 351. See *The Star Sea* [2001] UKHL 1, [2001] 1 Lloyd’s Rep. 389 (HL); *The Aegeon* [2002] EWCA Civ 247, [2002] 2 Lloyd’s Rep. 42.

<sup>734</sup> *Bank of Nova Scotia v Hellenic Mutual War Risks Association (The Good Luck)* [1988] 1 Lloyd’s Rep. 514, 546.

<sup>735</sup> A Naidoo & D Oughton, ‘The confused post-formation duty of good faith in insurance law: from refinement to fragmentation to elimination?’ (2005) *Journal of Business Law* 346, 350-1. A Naidoo & D Oughton analysed the decision of Lord Atkin in *Bell v Lever Bros Ltd* [1932] A.C. 161, 227 stating that ‘Lord Atkin observed that the duty was not contractual since it arises before the formation of the contract. The logic here is that an obligation existing prior to the formation of the contract cannot arise from the contract itself; and so the contract is not an appropriate place to start.’ At p. 350. See also, *K/S Merc-Scandia XXXXII v Lloyd’s Underwriters* [2001] EWCA Civ 1275; [2001] 2 Lloyd’s Rep. 563 [9] (Longmore LJ). See Norma Hird, ‘The saga of the continuing duty of utmost good faith--the sequel’ [2002] J.B.L. 328, 331 where the alignment of the remedy for breach of contract with retrospective avoidance for a breach of the good faith duty is regarded as ‘intellectually unsustainable’.

<sup>736</sup> [1989] 2 All ER 952, [1990] 1 QB 665, affirmed by House of Lords [1990] 2 All ER 947, 959, [1991] 2 AC 249, 280.

<sup>737</sup> *Manifest Shipping Co Ltd v Uni Polaris Shipping Co Ltd (The Star Sea)* [2001] UKHL 1, [2001] 2 WLR 170

<sup>738</sup> See, *ibid* [49].

application of a principle of law and not through an implied contractual term'.<sup>739</sup> His conclusion was based<sup>740</sup> on the decision of the Court of Appeal in *Banque Financière de la Cité SA v Westgate Insurance Co.*<sup>741</sup>

The other reason for not applying the duty of 'utmost good faith' in its full rigour is that the courts do not have enough case law or scenarios to develop a clear guideline for the duty. The problem voiced by Lord Clyde,<sup>742</sup> and Lord Hobhouse, is that 'when it comes to post-contract disclosure the criterion becomes more elusive'.<sup>743</sup> Lord Clyde further said that what 'has caused me greater difficulty is the broad provision in section 17 which appears to be unlimited in its scope'.<sup>744</sup> The wide nature of the duty has heavily confused the courts of South Africa that Appellate Division of the Supreme Court of the country, where the term is used by the Act with similar effects, commented that the 'expression *uberrima fides* was an alien, vague, useless expression without any particular meaning in law'.<sup>745</sup>

### 6.1.3 The Legal Position in Australia

Like English insurance law, the Insurance Contracts Act 1984 imposed the duty of utmost good faith. Unlike English law, the 1984 Act included it in the contract as an implied term, the breach of which would result breach of contract. Section 13 'A contract of insurance is a contract based on the utmost good faith and there is implied in such a contract a provision requiring each party to it to act towards the other party, in respect of any matter arising under or in relation to it, with the utmost good faith.'

This implied term prevails over any other terms in the contract. Section 14 says 'If reliance by a party to a contract of insurance on a provision of the contract would be to fail to act with the utmost good faith, the party may not rely on the provision'. Section 12 makes the duty paramount to anything else. The section further says that the duty does not have the effect of imposing on an insured, in relation to the disclosure of a matter to the insurer, a duty other than the duty of disclosure. The duty of disclosure is imposed by section 21 on the insured

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<sup>739</sup> *ibid* [46], [49], [71].

<sup>740</sup> *ibid* [46].

<sup>741</sup> [1989] 2 All ER 952, [1990] 1 QB 665, affirmed by House of Lords [1990] 2 All ER 947, 959, [1991] 2 AC 249, 280.

<sup>742</sup> *Manifest Shipping Co Ltd v Uni Polaris Shipping Co Ltd (The Star Sea)* [2001] UKHL 1, [2001] 2 WLR 170, [5].

<sup>743</sup> *ibid* [54].

<sup>744</sup> *ibid* [5].

<sup>745</sup> *Mutual & Federal Insurance Co Ltd v Audtshoorn Municipality* (1985) 1 AD 419, 433

before commencement of the contract. According to section 12 this duty cannot be invoked to compel further disclosure from the insured beyond the inception of the policy.<sup>746</sup> Accordingly, as in English insurance law, utmost good faith in Australian law does not impose any duty of disclosure during the policy.

However, the duty of utmost good faith in Australia itself imposes a heavier duty than that in England. It is heavier in nature because of the wider interpretation given to it by the courts. In *CGU Insurance Ltd v AMP Financial Planning Pty Ltd*,<sup>747</sup> the High Court of Australia gave three separate formulations of the duty,<sup>748</sup> the duty involves acting with 'due regard to the legitimate interests of the [other]',<sup>749</sup> of acting 'consistently with commercial standards of decency and fairness, with due regard to the interests of the [other]',<sup>750</sup> and exhibiting 'good faith in its utmost quality'.<sup>751</sup>

#### **6.1.4 Critical Analysis of the Australian Law**

Although the duty has been recognised as paramount, Australian law does not make it clear how this duty should be applied in the facts of the cases mentioned above. Moreover, section 12 provides that the said duty cannot be invoked to compel further disclosure beyond the inception of the policy, making it difficult for the insured to decide whether he should communicate the change of the risk to the insurer or not. However, unlike English courts, the courts and academics of Australia described the duty. The Full Court of the Federal Court stated that dishonesty is not the only conduct that amounts to a breach of the duty of utmost good faith, nor is dishonesty a prerequisite for a breach of the duty.<sup>752</sup> Justice Bollen of the Supreme Court of South Australia said that 'the obligation of the utmost good faith means what it says. It does not mean a measure of good faith. It means the utmost good faith'.<sup>753</sup>

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<sup>746</sup> See, *New South Wales Medical Defence Union Ltd v Transport Industries Insurance Co* (1985) 4 NSWLR 107; 3 ANZ Ins Cas 60-680; Matthew Ellis 'Utmost good faith: The scope and application of s 13 of the Insurance Contracts Act in the wake of *CGU v AMP*' (2009)20 ILJ 92, 102.

<sup>747</sup> (2007) 237 ALR 512, [2007] HCA 38; BC200707216.

<sup>748</sup> Though they are given in relation to the duty of utmost good faith of the insurer, they can also be used for the duty of utmost good faith of the insured.

<sup>749</sup> (2007) 237 ALR 512; [2007] HCA 38; BC200707216, [15] (Gleeson CJ and Crennan J, citing Stephen J in *Distillers Co Bio-Chemicals (Aust) Pty Ltd v Ajax Insurance Co Ltd* (1974) 130 CLR 1, 31; 2 ALR 321; BC7400610).

<sup>750</sup> (2007) 237 ALR 512; [2007] HCA 38; BC200707216 [15] (Gleeson CJ and Crennan J).

<sup>751</sup> *ibid* [176] (Kirby J).

<sup>752</sup> *AMP Financial Planning Pty Ltd v CGU Insurance Ltd* (2005) 146 FCR 447, 475; 55 ACSR 305, 331; [2005] FCAFC 185; BC200506441 (Emmett J). See also *Kelly v New Zealand Insurance Co Ltd* (1993) 7 ANZ Ins Cas 61-197; BC9301461, 78,258 (Owen J); F Hawke, 'Utmost Good Faith -- what does it really mean?' (1994) 6 ILJ 91.

<sup>753</sup> *Sheldon v Sun Alliance* (1989) 53 SASR 97 at 152.



Callan O'Neill commented that '[w]hether the duty has been breached is measured objectively on a case by case basis that involves an examination of whether a reasonable person in the circumstances of the party to the relationship of insurance would have taken the action alleged to be in breach'.<sup>754</sup>

The duty is well described by Matthew Ellis, who states that

A few issues arise...First, the High Court has confirmed that honesty is not an essential component of the duty of utmost good faith. It is one aspect of the reasonable commercial standards of decency and fairness that may be applicable in some circumstances. Therefore, it is questionable whether the test to be applied in determining whether a breach of the duty has occurred involves the subjective limb. Second, the case law does not support the argument that a mistake, or an act of negligence, will not amount to a breach of the duty of utmost good faith. Nor does the case law support the contention that breach of the duty requires intent. A mistake or an act of negligence could amount to unreasonable conduct, which could objectively amount to a breach of the duty of utmost good faith. Take for example an insurer, which makes no decision in respect of indemnity for a substantial period of time following receipt of claim. In determining whether the insurer has breached the duty, the court will consider whether the delay in making a decision was unreasonable. Regardless of whether the delay was caused by, for example, the insurer's negligent failure to consider the law applicable to the claim or its careless misplacing of documents relevant to the determination, the delay may still amount to a breach of the duty of utmost good faith. That is because, objectively, commercial standards of fairness and decency require claims to be managed expeditiously, and with due regard to the interests of the insured.<sup>755</sup>

The courts and academics in Australia have described the duty well but none attempted to define it,<sup>756</sup> because the duty 'changes slightly throughout the growth of the contractual relationship itself'.<sup>757</sup> Further, some academics and judges believe that any 'attempt to define the duty with more precision will render the duty too inflexible for universal application'.<sup>758</sup>

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<sup>754</sup> 'A Pot of Gold? The Unfinished Story of Utmost Good Faith and the Insurance Contracts Act' (2008) 19 Insurance Law Journal 245, 249; see also K Godfrey, 'The duty of utmost good faith — The great unknown of modern insurance law' (2002) 14 ILJ 1, 3

<sup>755</sup> Matthew Ellis 'Utmost good faith: The scope and application of s 13 of the Insurance Contracts Act in the wake of *CGU v AMP*' (2009)20 ILJ 92, 110.

<sup>756</sup> For more description of the term see, R Loo, 'The duty of utmost good faith — is the duty and expanding?', Allens Arthur Robinson Insurance and Reinsurance Focus, May 2001 <<http://www.aar.com.au/pubs/insur/insmay01a.htm>> accessed 2nd November 2010; *Kelly v New Zealand Insurance Co Ltd* (1993) 7 ANZ Ins Cas 61-197; BC9301461 at 78,258 (Owen J); K Godfrey, 'The duty of utmost good faith — the great unknown of modern insurance law' (2002) 14 ILJ 56, 57 and C O'Neill, 'A pot of gold? The unfinished story of utmost good faith and the Insurance Contracts Act' (2008) 19 ILJ 245, 248-9; *CGU Insurance Ltd v AMP Financial Planning Pty Ltd* (2007) 235 CLR 1; 237 ALR 420; 81 ALJR 1551; [2007] HCA 36; BC200707214, 257.

<sup>757</sup> Callan O'Neill 'A Pot of Gold? The Unfinished Story of Utmost Good Faith and the Insurance Contracts Act' (2008) 19 ILJ 245, 249; see also S Drummond, 'Unconscionable conduct and utmost good faith' (2003) 14

### 6.1.5 Recommendation

It is evident from the above analysis that everyone feels that the duty to act with utmost good faith exists throughout the policy, but it is unclear what the nature of this duty is in the different stages of the contract. Failing to find the exact nature of the duty, the courts rely on the terms and conditions of the contract to prevent the insured to act in a manner that goes against the rule of utmost good faith. This works like a painkiller, given by a doctor who has no idea about the reason and nature of the pain. The painkiller may kill the pain for a certain period, but it is not the right treatment. Similarly, the current approach of the court may benefit the parties in some respects, but it is not the right one. In order to find the right approach, it is required to have a clear understanding of what the duty is and what its nature is. The nature of the duty can be found by analysing the interests of both parties.

Once a policy is taken, the insurer obtains an interest on the property in the sense that the occurrence of the peril to the property shall cost him money and its safety shall save his money. It works like two persons have bought a house with unequal shares.<sup>759</sup> The person who has got the majority share cannot do something with the property that may affect the other's interest without his consent. The insured in an insurance contract is like the person with majority share and the insurer is like the person with minority share. Common sense suggests that the insured should not be allowed to do something with the property that may risk the interest of the insurer without his consent. Consequently, the law should impose a duty on the insured that shall restrain him from doing something that may affect the interest of the insurer.

However, the U.S. Court of Appeal found a drawback of requiring the insured to disclose or getting consent for any change in the insured property. The court stated that 'whatever the

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ILJ 1, 3; K Godfrey, 'The duty of utmost good faith — The great unknown of modern insurance law' (2002) 14 ILJ 1, 2

<sup>758</sup> Matthew Ellis 'Utmost good faith: The scope and application of s 13 of the Insurance Contracts Act in the wake of *CGU v AMP*' (2009) 20 ILJ 92, 111; Justice M Kirby, 'Marine Insurance: Is the Doctrine of 'Utmost Good Faith' Out of Date?' (1995) 13(2) Aust Bar Rev 1, 19.

<sup>759</sup> See the Scottish case *Fagnoli v GA Bonus Plc* [1997] CLC 653 where Lord Penrose compared the relationship with that of with partners. As He said at page 673 'Similar considerations obtain in the case of other contracts where utmost good faith is required, as in partnership, where there is a general requirement for disclosure by existing partners of facts which might influence a prospective partner in deciding whether to join the firm: *Ferguson v Wilson* (1904) 6 F 779.' See also, Matthew Ellis, 'Utmost good faith: The scope and application of s 13 of the Insurance Contracts Act in the wake of *CGU v AMP*' (2009) 20 Insurance Law Journal 92.

exact extent of the applicability of the strict *uberrimae fidei* standard, we cannot believe that in these times it requires a pleasure boat owner to notify the insurer every time the craft takes on a small amount of water, or has engine trouble, at pain of losing coverage'.<sup>760</sup>

Following the above argument, it is submitted that the duty of utmost good faith should not strictly require the insured to contact the insurer for every change. It should simply require the insured not to do something with the insured object that will affect the insurer's interest. Solicitor Roger Loo suggested, a similar approach, that the duty should be a combination of subjective and objective components; namely, would a reasonable person (objective) with the knowledge of the particular insurer/insured (subjective) engage in the relevant conduct?<sup>761</sup> Callinan and Heydon JJ stated that 'utmost good faith will usually require something more than passivity: it will usually require affirmative or positive action on the part of a person owing a duty of it'.<sup>762</sup> In his dissenting judgement in *CGU Insurance Ltd v AMP Financial Planning Pty Ltd*,<sup>763</sup> Kirby J suggested that breach of the duty would occur where dishonesty, caprice or unreasonableness was demonstrated.

Considering the aforementioned analysis and the views of academics and justices the author recommends that *during the period of the policy the insured should be under the duty not to do something with the insured object that effectively concerns the insurer about its safety against the peril unless a reasonable insured would do had there been no insurance policy or he obtains consent from the insurer. However, if the change to the insured object occurs without the control of the insured, the insured is not required to inform the insurer about the change.*

#### **6.1.5.1 Justifiable for the Insured**

Other than observing utmost good faith, the current law fails to let the insured know his exact duty during the policy. Since the nature of the duty is clear to no one, the honest insured is confused as to how he should treat the insured property, and the dishonest insured attempts to

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<sup>760</sup> In *Windsor Mount Joy Mut. Ins. Co v Giragosian* 57 F. 3d 50, 55 (1st Cir., 1995).

<sup>761</sup> Roger Loo, 'The duty of utmost good faith — is the duty expanding?' (May 2001) Allens Arthur Robinson Insurance and Reinsurance Focus <<http://www.aar.com.au/pubs/insur/insmay01a.htm>> accessed 2nd November 2010. See, Callan O'Neill 'A Pot of Gold? The Unfinished Story of Utmost Good Faith and the Insurance Contracts Act' (2008) 19 ILJ 245, 249; K Godfrey, 'The duty of utmost good faith — The great unknown of modern insurance law' (2002) 14 ILJ 1, 3

<sup>762</sup> *CGU Insurance Ltd v AMP Financial Planning Pty Ltd* (2007) 235 CLR 1; 237 ALR 420; 81 ALJR 1551; [2007] HCA 36; BC200707214, 257.

<sup>763</sup> (2007) 235 CLR 1; 237 ALR 420; 81 ALJR 1551; [2007] HCA 36; BC200707214, 139.

take unethical benefit from the policy by negligently increasing the risk. The recommended duty shall help the honest insured to find the guidelines as to how he should treat the insured property and the dishonest insured shall be refrained from acting with bad faith. Moreover, there are cases where the claims have been refused by the insurer simply on the grounds of nondisclosure of the change of risk.<sup>764</sup> By acting upon this clear and specific duty, the insured can secure the policy against such allegations from the insurer.

Further to that, under the current law the courts did not make any difference between the change caused by the insured and the change caused by the nature. The author's recommended duty should save an insured from the effect of nondisclosure when the said change occurred without his control. For example, if any change is caused by the nature to the above mentioned pleasure boat, the insured does not need to inform the insurer. In another case, the insurer argued that the insured should have notified him as soon as cancer was diagnosed.<sup>765</sup> However, the insured is not required to disclose this fact to the insurer according to the author's recommended duty. The insured needs the insurer's consent only when he does an act that a reasonable insured would not have done if there been no policy.<sup>766</sup> The recommended duty, however, does not require the insured, to disclose something that is discovered after taking the policy. This follows the existing law.

#### **6.1.5.2 Justifiable for the Insurer**

After a policy is issued, the insurer automatically becomes concerned about the safety of the insured object since the loss of that object will make him suffer. Consequently, any change to the insured object that increases the risk of peril affects the interest of an insurer. Hence, logic suggests that the insured should be stopped from unreasonably increasing the risk of peril by making change to the object. However, the insured should be allowed to change the object in the manner that a reasonable person would do had there been no policy so as to let

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<sup>764</sup> *Hussain v Brown (No 2)* (unreported, 1996). The case is discussed in *Insurance Law Monthly* (1997) 9 ILM 4; *Kausar v Eagle Star Insurance Co Ltd* [2000] Lloyd's Rep 154; *Pim v Reid* (1843) 6 M & G 1.

<sup>765</sup> The case is referred by the Law Commission in their *The Insured's Post-Contract Duty of Good Faith* (Issues Paper 7, July 2010) para 6.39.

<sup>766</sup> For example, an insured has taken a policy on his car against theft and received discount for having the facility of garage. Two months after taking the policy the insured has started construction of the garage which made him park the car outside. The area where the insured lives has got bad reputation about the security of cars. In such case the recommended duty requires the insured to act in a way that a reasonable insured would do had there been no policy. It is assumed that the reasonable insured might have rented a garage or park in neighbour's or friend's garage or park in any other secured place. Consequently, the duty requires the insured to act in the way that the reasonable insured would do, otherwise he has to get the consent from the insurer to park outside of his house.

him enjoy the object in reasonable manner. Hence, the recommended duty will establish a fair balance benefitting both the insured and insurer.

### 6.1.6 The Duty of the Insured under Shairah Principles

Whilst shariah principles strictly maintain the duty of utmost good faith,<sup>767</sup> its nature in the insurance contract, as mentioned above, has not been specifically defined. In such cases, the basic guidelines need to be followed, the process is known as Qiyas. The basic guidelines are to maintain honesty, kindness to other party, justice and openness in the transaction. Imam Muslim said,

A careful study of “Kitab al-Buyu” (the book pertaining to business transactions) will reveal the fact that the Holy Prophet (may peace be upon him) based business dealings strictly on truth and justice. He has strongly disapproved of all transactions which involve any kind of injustice or hardship to the buyer or the seller. He wanted that both, the buyer and the seller, be truly sympathetic and considerate towards each other. One should not take undue advantage of the simplicity or ignorance of the other. The seller should not think that he has unrestricted liberty to extort the buyer as much as possible. He has to be just; he should take his own due and give the buyer what is his.<sup>768</sup>

According to the Islamic rule ‘All transactions should be based on the fundamental principle of’ Ta’auanu ala birri wa’t-taqwa’ (mutual co-operation for the cause of goodness or piety). A transaction not based upon this sound principle is not lawful’.<sup>769</sup> As Allah Ta’ala says in the Quran:

ان الله يأمركم بالعدل والاحسان

*Allah commands (people) to maintain Justice and kindness.*<sup>770</sup>

He further says,

ولايجرمنكم شئان قوم علس ألاتعدلوا اعدلوا هوأقرب للتقوي

*And let not the enmity and hatred of others make you avoid justice. Be just: that is nearer to piety.*<sup>771</sup>

<sup>767</sup> This issue has been analysed in previous chapters.

<sup>768</sup> Abdul Hamid Siddiqi (tr), *Sahih Muslim* (SH. Muhammad Ashraf, Kashmiri Bazar, Lahore, Pakistan 1973) Vol III, 792.

<sup>769</sup> A A Muslim *Sahih Muslim*, باب تَحْرِيمِ الظُّمِّ وَالصَّلَاةِ وَالْأَدَابِ - باب تَحْرِيمِ الظُّمِّ No. 2577; Abdul Hamid Siddiqi (tr), *Sahih Muslim* (SH. Muhammad Ashraf, Kashmiri Bazar, Lahore, Pakistan 1973) Vol III, 792.

<sup>770</sup> *The Holy Quran*, 16: 90.

<sup>771</sup> *ibid* 5: 8.

According to the above analysis, the effectiveness of current English law in the application of utmost good faith is doubtful. In some cases this can be oppressive on the insurer by depriving him of his interest on the insured property. It has been argued that the insurer's interest is the safety of the property and as such he has the right to oppose any act that may increase the risk of the property. However, English law allows the insured to perform such an act without the insurer's consent, thus depriving him of his right to oppose as well as increase his risk of losing money. Consequently, the insurer becomes the victim of injustice and oppression, which Shariah principles do not allow. Prophet Muhammad (PBUH) said

عَنْ أَبِي ذَرٍّ عَنِ النَّبِيِّ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ فِيمَا رَوَى عَنْ اللَّهِ تَبَارَكَ وَتَعَالَى أَنَّهُ قَالَ يَا عِبَادِي إِنَّ حَرَمْتُ  
الظُّلْمَ عَلَى نَفْسٍ وَجَعَلْتُهُ بَيْنَكُمْ مُحَرَّمًا فَلَا تَظَالَمُوا...

*Abu Dharr reported Allah's Messenger (may peace be upon him) as saying that Allah, the Exalted and Glorious, said: My servants, I have made oppression unlawful for Me and unlawful for you, so do not commit oppression against one another...*<sup>772</sup>

In such circumstances, a fair duty is required for an insured in an Islamic insurance contract. Following the aforementioned analysis, it is argued that the author's recommended duty for English insurance law is fair and reasonable and as such it should be Shariah compliant. Consequently, imposition of the recommended duty under English insurance law would benefit this legal system by way of having a fair and reasonable duty for the insured and the Islamic insurers by way of having an adequate legal support for the application of Islamic policies. However, until English insurance law applies that duty, an Islamic insurer should incorporate the following term so as to avoid the injustice caused by the current English law duty and make the policy Shariah compliant: *during the period of the policy the insured shall not do something with the insured object that effectively concerns the insurer about its safety against the peril unless a reasonable insured would do the same had there been no insurance policy or he obtains consent from the insurer.*

<sup>772</sup> A. A. Muslim, *Sahih Muslim*, (USC Centre for Muslim-Jewish Engagement tr, <<http://www.usc.edu/org/cmje/religious-texts/hadith/muslim/032-smt.php>>) Book 032, Number 6246. Accessed 05/07/2013.

## **6.2 Duty of the Insurer at the Second Stage of the Contract - During the Policy**

As stated above, section 17 imposes the duty to observe utmost good faith on both parties. As is the case with the insured, the Act fails to define the duty of the insurer during the policy. This is a neglected issue, because for obvious reasons, the courts, academics and the Law Commission<sup>773</sup> are mostly concerned about the insurer's duty during the claim procedure instead of during the policy. However, the importance of the insurer's duty in this period cannot be underestimated because the insured has obtained the interest on insurer's business by purchasing the security from the insurer for his property in return of money. It is like the relationship between a company and its shareholders. If the company makes any change that concerns the shareholders, the company has to inform them and in some cases the company needs their consent to make the change. Similarly, the insured's interest shall be affected if the insurer does something that affects his business making him incapable to meet the claim of the insured. In such cases regulatory body like FSA will take steps against that insurer, as they did against Drake Insurance Plc.<sup>774</sup> Consequently, the interest of the insured is secured following the actions taken by the regulatory board and as such there is no requirement of having separate duty on an insurer for the interest of the insured and the courts also do not recognise such duty. Hence, no further analysis or recommendation is required in this case.

## **6.3 Duty of the Insured at the Third Stage of the Contract – The Claim Stage**

### **6.3.1 Duty under English Insurance Law**

It has already been analysed that section 17 imposes the duty throughout the policy. The remedy for breach of this duty is also imposed by the same section. The courts have found that the remedy is unnecessarily harsh,<sup>775</sup> and as such attempted to impose the duty in a different manner to avoid the effect of the remedy. Hirst J in *The Litsion Pride* imposed the duty through implied term.<sup>776</sup> This approach was approved by Evan J in *Continental Illinois National Bank & Trust Co of Chicago v Alliance Insurance Co Ltd; The Captain Panagos*

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<sup>773</sup> In their recent issues paper on insurer's duty the Law Commission considered only the duty at the claim procedure, see, 'Damages for Late Payment and the Insurer's Duty of Good Faith (Issues Paper 6, 2010) para, 4.17.

<sup>774</sup> Drake Insurance Plc have been overloaded by the policy and failed to produce an adequate plan to remedy the situation. This led to the FSA appointing Provisional Liquidators on 12 May 2000. See, FSA/PN/057/2000 released on 09/05/2000 <<http://www.fsa.gov.uk/Pages/Library/Communication/PR/2000/057.shtml>> See also, 'Directors of Black and White Group Limited fined and banned for widespread mortgage and PPI failings' (12 December 2012) FSA/PN/112/2012

<sup>775</sup> *Manifest Shipping Co Ltd v Uni Polaris Shipping Co Ltd (The Star Sea)* [2001] UKHL 1, [2001]2 WLR 17 [51] (Lord Hobhouse).

<sup>776</sup> *Black King Shipping Corporation v Massie; The Litsion Pride* [1985]1 Lloyd's rep 437, 518-519.

DP.<sup>777</sup> Lord Atkin, on the other hand, observed in *Bell v Lever Bros Ltd*,<sup>778</sup> that the duty was not contractual since it arises before the formation of the contract.<sup>779</sup> ‘The logic here is that an obligation existing prior to the formation of the contract cannot arise from the contract itself, and so the contract is not an appropriate place to start’.<sup>780</sup> In *Banque Keyser Ullmann SA v Skandia Insurance Co*,<sup>781</sup> Steyn J refused to apply the implied term theory. In the subsequent case *Orakpo v Barclays Insurance Services*,<sup>782</sup> the Court of Appeal split into two parts on this issue. The majority, constituted by Hoffman LJ and Sir Roger Parker, held that the duty was a contractual duty implied as a matter of law.<sup>783</sup> The minority opinion of Staughton LJ was that there was no authority that there was an implied term against the making of fraudulent claims, nor was it necessary to imply such a term because it was obvious or for reasons of business efficacy.<sup>784</sup> In two subsequent cases *Manifest Shipping Co Ltd v Uni Polaris Shipping Co Ltd (The Star Sea)*<sup>785</sup> and *Royal Boskalis Westminster NV v Mountain*<sup>786</sup> Tuckey J and Rix J, respectively, rejected the wider duty holding that the duty is only not to make fraudulent claim. Rix J held that the wider duty would cause difficulty in drawing the boundary and also unexpected dramatic consequences would be flowed from the most innocent or indeed any non-fraudulent nondisclosure in the presentation of a claim.<sup>787</sup> Both the Court of Appeal<sup>788</sup> and House of Lords<sup>789</sup> in *The Star Sea*,<sup>790</sup> confirmed this view. In

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<sup>777</sup> [1986]2 Lloyd’s Rep 470, [1989]1 Lloyd’s Rep 33. See also *Banque Financiere de la Cite v Westgate Insurance Co Ltd (sub nom Banque Keyser Ullman SA v Skandia (UK) Insurance Co Ltd)* [1990]2 ALL ER 947, 960 (Lord Jauncey).

<sup>778</sup> [1932] A.C. 161.

<sup>779</sup> *ibid* 227.

<sup>780</sup> A Naidoo & D Oughton, ‘The confused post-formation duty of good faith in insurance law: from refinement to fragmentation to elimination?’ (2005) *Journal of Business Law* 346, 350.

<sup>781</sup> [1987] 1 Lloyd’s Rep. 69, reversed by the Court of Appeal in *Banque Financière de la Cité v Westgate Insurance Co Ltd* [1990] 1 QB 665 on the matter of wrongful repudiation and its consequences. See also, *Sparenborg v Edinburgh Life Assurance* [1912] 1 K.B 85.

<sup>782</sup> [1994] CLC 373. This judgment was approved by the Court of Appeal in *Galloway v Guardian Royal Exchange (UK) Ltd* [1999] Lloyd’s Rep IR 209, where the assured fraudulently included a claim for an item of loss together with genuine losses, on the ground that the losses all were caused by the one burglary. See also *Chapman v Pole* (1870) 22 LT 306.

<sup>783</sup> *ibid* 383 (Hoffmann LJ), 384-385 (Sir Roger Parker).

<sup>784</sup> *ibid* 382-383. A contrary opinion was reached by Millett, LJ in *Galloway v Guardian Royal Exchange (UK) Ltd* [1999] Lloyd’s Rep IR 209, 214.

<sup>785</sup> [1995]1 Lloyd’s Rep 651, 667-668.

<sup>786</sup> [1997] LRLR 523

<sup>787</sup> *Royal Boskalis v Mountain* (unreported, 18 December 1995) 256 (Rix J).

<sup>788</sup> [1997]1 Lloyd’s Rep 360. See also *Gate v Sun Alliance Insurance Ltd* [1995] LRLR 385, 423 (Fisher J); *The Standard Steamship Owners’ Protection and Indemnity Association (Bermuda) Ltd v Oceanfast Shipping Ltd; (The Ainikolas I)* (QBD (Comm Ct) Lexis Transcript, 7 March 1996). *Cf Fagnoli v G A Bonus plc* [1997] CLC 653 (Court of Session).

<sup>789</sup> *Manifest Shipping Co Ltd v Uni Polaris Shipping Co Ltd (The Star Sea)* [2001] UKHL 1, [2001]2 WLR 170.

<sup>790</sup> *ibid*. See also *Gate v Sun Alliance Insurance Ltd* [1995] LRLR 385, 423 (Fisher J); *The Standard Steamship Owners’ Protection and Indemnity Association (Bermuda) Ltd v Oceanfast Shipping Ltd; (The Ainikolas I)*



*Agapitos v Agnew; The Aegeon*,<sup>791</sup> Mance LJ distinguished a fraudulent claim from the use of a fraudulent device in connection with a claim. He, however, said that both fraudulent claim and fraudulent device should be governed by common law.<sup>792</sup> According to the latest decisions the duty is a common law duty which merely requires the insured to refrain from making fraudulent claims.<sup>793</sup> In *Agapitos v Agnew*<sup>794</sup> Mance LJ proffers that the common law rules should be applied to govern the duty at this stage.<sup>795</sup>

However, it appears that the latest courts are of the opinion that the common law duty should be applied at the claim stage which merely requires the insured to refrain from making fraudulent claims. Longmore LJ, however, held in *The Mercandian Continent*,<sup>796</sup> that section 17 duty can be applied but only if two conditions are satisfied, that the fraud must have been material in that it had an effect on the insurer's ultimate liability, and the gravity or consequences of the fraud must be such that would entitle the insurer to terminate the contract for breach of contract. This decision was accepted by Mance LJ in *gapitos v Agnew; The Aegeon*.<sup>797</sup> However, MacGillivray pointed out that in most of the cases the fraud is material and would be sufficient to allow the insurer to repudiate satisfying both tests.<sup>798</sup>

In conclusion, the status of current law is that the common law duty of utmost good faith is applicable during the claim stage. The duty is to refrain from making fraudulent claims.<sup>799</sup> The duty under section 17 can only be applied in limited circumstances when the alleged

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(QBD (Comm Ct) Lexis Transcript, 7 March 1996). *Cf Fargnoli v G A Bonus plc* [1997] CLC 653 (Court of Session).

<sup>791</sup> [2002] EWCA Civ 247; [2002] 3 WLR 616.

<sup>792</sup> *ibid* [45].

<sup>793</sup> The fraudulent claim is defined by Roche J in *Wisenthal v World Auxiliary Insurance Corporation Ltd* (1930) 38 Ll L Rep 54, 61-62, as one that includes a claim which is falsely made with the intention of securing an advantage from the insurer to the assured. In *Lek v Mathews* (1927) 29 Ll L Rep 141, 145, Viscount Sumner stated that a claim shall be false not only 'if it is deliberately invented but also if it is made recklessly, not caring whether it is true or false but only seeking to succeed in the claim'. See also *Dome Mining Corporation Ltd v Drysdale* (1913) 41 Ll L Rep 109, 120-122, 130-131 (Branson J); *Bonney v Cornhill Insurance Company Ltd* (1931) 40 Ll L Rep 39; *Galle Gowns Ltd v Licenses & General Insurance Co Ltd* (1933) 47 Ll L Rep 186; *Haase v Evans* (1934) 48 Ll L Rep 131; *Wisenthal v World Auxiliary Insurance Corporation Ltd* [1956] 2 Lloyd's Rep 240.

<sup>794</sup> [2002] Lloyd's Rep. I.R. 573

<sup>795</sup> *ibid* [45].

<sup>796</sup> *K/S Merc-Scandia XXXXII v Certain Lloyd's Underwriter; The Mercandian Continent* [2001] EWCA Civ 1275; [2001] 2 Lloyd's Rep 563, [30], [35], [40].

<sup>797</sup> [2002] EWCA Civ 247; [2002] 3 WLR 616 [43].

<sup>798</sup> Nicholas Legh-Jones QC, John Birds and David Owen (eds), *Macgillivray on Insurance Law* (11<sup>th</sup> edn, Sweet & Maxwell 2008) para 19-065.

<sup>799</sup> The academics have got the similar opinion. See for instance, Professor Malcolm A Clarke *The Law of Insurance Contracts* (6<sup>th</sup> edn, Informa 2009) 879-883.

breach justifies the avoidance of the contract *ab initio*,<sup>800</sup> and it is done fraudulently which has an effect on the insurer's ultimate liability.

### 6.3.2 Critical Analysis of the English Insurance Law

The aforementioned views of the courts represent the fact that the courts have different opinions regarding the nature of the duty, but there is no dispute that it involves not making fraudulent claims. Other than this, the courts do not impose any duty on the insured to disclose particular facts that may affect the decision of the insurer in handling the claim. In such circumstances, investigations are required for the insurer to discover these particular facts. This investigation would not be necessary if the insured had been required to disclose those facts that he found important for the insurer to know. That part of the duty would save the time and cost caused by investigations. The courts, however, backed their decision for not extending the duty to this extent by holding that fixing of the yardstick to measure materiality would be difficult.<sup>801</sup> In contrast, when imposing the duty of disclosure of material facts before making contract, the courts are disregarding this difficulty.

Moreover, there are similarities between the duty before making contract and the duty at the time of making claim. In both cases, the insured asks for something, such as to cover the risk in the earlier case and to cover damage in the latter case. In both cases the insured has to honestly disclose the object, such as the risk in the earlier case and the incidence that caused the peril and the amount lost in the latter case.<sup>802</sup> In both of these cases, the insured is the person who possesses all the information that the insurer wants to know about. The only dissimilarity that the court finds in these two cases is that the insurer is required to disclose the material fact in the earlier case because the insurer is in the position to take the risk and in the latter case the purpose of disclosure, the taking of the risk has already occurred.<sup>803</sup> However, similarity can also be found on this point, as the purpose of disclosure when seeking a policy is to evaluate the risk and the purpose of disclosure when making a claim is

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<sup>800</sup> See for instance *Manifest Shipping Co Ltd v Uni Polaris Shipping Co Ltd (The Star Sea)* [2001] UKHL 1, [2001]2 WLR 170 [51] (Lord Hobhouse).

<sup>801</sup> *Manifest Shipping Co Ltd v Uni Polaris Shipping Co Ltd (The Star Sea)* [2001] UKHL 1, [2001]2 WLR 170 [109] (Lord Scott).

<sup>802</sup> The Law Commission said that in an insurance contract the insurer needs to be confident that the policyholder has 'acted honestly in making a claim', at *The Insured's Post-Contract Duty of Good Faith* (Issues Paper 7, July 2010) para 1.6.

<sup>803</sup> See, *Manifest Shipping Co Ltd v Uni Polaris Shipping Co Ltd (The Star Sea)* [2001] UKHL 1, [2001]2 WLR 170 [54] (Lord Hobhouse).

to evaluate the claim. The similar effects of the duty of disclosure in both stages demand a similar category of duty, which is to disclose necessary information.

The duty of disclosure at the claim stage is further reasoned by the argument that the duty of utmost good faith is mutual,<sup>804</sup> and as such the insured carries the duty to make sure that the insurer is not in loss or in difficulty due to his failure to act that logic suggests him to do so.<sup>805</sup> This mutual duty is applied effectively by the English law before making the contract, but no such duty is present at the claim stage. Restraining the insured from making fraudulent claim cannot fulfil the element of mutuality. Consequently, the current duty at the claim stage is inadequate.

The Scottish Court in *Fagnoli v GA Bonus Plc*,<sup>806</sup> applied the mutual duty during the claim procedure and held:

Not only does the insured have control of the information required at the outset for the assessment of risk, if a casualty should occur he has at the date of making the claim exclusive control of the information on which the claim must be based. The insured is, typically, the dominant party in terms of having available relevant information. The risk of fabrication in such circumstances is real.<sup>807</sup>

The Law Commission regretted that the English courts in subsequent cases did not consider this view, as they think that this was the helpful way ‘to conceptualise the duties’.<sup>808</sup> Furthermore, Lord Mansfield stated that the purpose of the imposition of utmost good faith was to prevent the insured from deceiving the insurer.<sup>809</sup> The insurer is deceived by misrepresentation or nondisclosure of a fact, which made him take the risk in a way that he would not have taken had he known the fact.<sup>810</sup> The insurer may also be deceived at the claim stage by the nondisclosure of a fact which would make him pay the claim, which he would

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<sup>804</sup> See, *Manifest Shipping Co Ltd v Uni Polaris Shipping Co Ltd (The Star Sea)* [2001] UKHL 1, [2001]2 WLR 170 [79] (Lord Hobhouse).

<sup>805</sup> *Carter v Boehm* (1766) 97 E.R. 1162, 1164, ‘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 the contrary.’ (Lord Mansfield).

<sup>806</sup> 1997 SCLR 12; [1997] CLC 653.

<sup>807</sup> *ibid* 673 (Lord Penrose).

<sup>808</sup> The Law Commission and Scottish Law Commission, *The Insured’s Post-Contract Duty of Good Faith* (Issues Paper 7, July 2010) para 4.56.

<sup>809</sup> *Carter v Boehm* (1766) 97 E.R. 1162, 1164.

<sup>810</sup> *ibid* 1164.

not have paid had he known the fact.<sup>811</sup> Consequently, the insurer is deceived, according to the view of Lord Mansfield,<sup>812</sup> by the nondisclosure of material facts that made him treat the claim in a way that he would not have done had he known the fact. There can be an argument that to protect his interests, the insurer should investigate the claim, before paying out and as such there should not be any requirement of disclosure. In reply, it could be said that the same investigation could be expected from the insurer before taking the policy, but the courts defended the latter position by holding that the insured possesses all the information and as such it is his duty to disclose.<sup>813</sup> The insured is also in possession of information that the insurer would want to know about at the claim stage and as such the same defence could be applied at the claim stage.<sup>814</sup> Accordingly, logic suggests that the duty of disclosure should also be applicable at the claim stage but in a different manner that suits the demand.<sup>815</sup>

The courts further failed to determine the duty of not being negligent due to their extreme concentration on the honesty of the insured in presenting the claim. However, the duty under the term utmost good faith or mind requires some positive act.<sup>816</sup> In this context, it is worthwhile to restate the Australian High Court's approach towards this term. The court provided three aspects of the duty under this term,<sup>817</sup> that each party needs to act with 'due regard to the legitimate interests of the [other],<sup>818</sup> this means acting 'consistently with commercial standards of decency and fairness, with due regard to the interests of the [other],<sup>819</sup> and exhibit 'good faith in its utmost quality'.<sup>820</sup> An insurance contract creates an interest of the insurer in the insured object along with the insured creating a mutual

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<sup>811</sup> Following the decision in *Great Peace Shipping Ltd v Tsavliris Salvage (International) Ltd* [2002] EWCA Civ 1407, [2003] Q.B. 679 the insurer cannot claim the payment back on the ground of mistake of fact.

<sup>812</sup> *Carter v Boehm* (1766) 97 E.R. 1162, 1164.

<sup>813</sup> *ibid* 1164 (Lord Mansfield).

<sup>814</sup> See, *Fagnoli v GA Bonus Plc* [1997] CLC 653, 673 (Lord Penrose); Law Commission and Scottish Law *The Insured's Post-Contract Duty of Good Faith* (Issues Paper 7, July 2010) para 2.1.

<sup>815</sup> See, S Drummond, 'Unconscionable conduct and utmost good faith' (2003)14 ILJ 1, 3.

<sup>816</sup> See, *CGU Insurance Ltd v AMP Financial Planning Pty Ltd* (2007) 235 CLR 1; 237 ALR 420; 81 ALJR 1551; [2007] HCA 36; BC200707214 at 257 (Callinan and Heydon JJ); See also, Fred Hawke 'Utmost Good Faith - What Does it Really Mean?' (1994) 6 ILJ 91; Professor Steven J Burton 'Breach of Contract and the Common Law Duty to Perform in Good Faith' (1980) 94 Harv LR 369.

<sup>817</sup> *CGU Insurance Ltd v AMP Financial Planning Pty Ltd* (2007) 237 ALR 512; [2007] HCA 38; BC200707216. Though they are given in relation to the duty of utmost good faith of the insurer, they can also be used for the duty of utmost good faith of the insured.

<sup>818</sup> *ibid* [15] (Gleeson CJ and Crennan J, citing Stephen J in *Distillers Co Bio-Chemicals (Aust) Pty Ltd v Ajax Insurance Co Ltd* (1974) 130 CLR 1, 31; 2 ALR 321; BC7400610).

<sup>819</sup> (2007) 237 ALR 512; [2007] HCA 38; BC200707216 [15] (Gleeson CJ and Crennan J).

<sup>820</sup> *ibid* [176] (Kirby J).

relationship.<sup>821</sup> Both parties have the interest of being saved from loss. If one does not act with utmost good mind/faith, the other shall suffer a loss. Accordingly, the duty should be to act with utmost good faith, not merely to refrain from fraudulent claim. The utmost good faith duty requires the insured to act in a way that does not affect the interest of the other party interested in the property. As such he cannot be negligent in making a claim, disclosing the material facts even if the disclosed facts provide a defence for the insurer against the claim and also cannot be fraudulent.

### 6.3.3 Approach of the Law Commission

The Law Commission supports the current approach of confining the duty to not making fraudulent claims.<sup>822</sup> They are of the view that the duty at this stage should be ‘good faith’ instead of ‘utmost good faith’.<sup>823</sup> The possible difficulties of the mere duty not to make fraudulent claim have been discussed above. The application of ‘good faith’ instead of ‘utmost good faith’ shall cause further problems and this is discussed below.

### 6.3.4 The Legal Position in Australia

Section 13 of Insurance Contracts Act 1984, as discussed above, makes the duty of utmost good faith implied in the contract. This implied term theory was applied in English law by Hirst LJ in *Litsion Pride*,<sup>824</sup> but was rejected by subsequent cases on the grounds that the duty under implied term would be too wide, the boundary of which would be hard to fix. The boundary in Australian legal system has not been fixed by the Act but has been explained by the court in *CGU Insurance Ltd v AMP Financial Planning Pty Ltd*,<sup>825</sup> that dishonesty is not to be considered central to the duty. It rather should be governed by commercial standards of decency, fairness and reasonableness. In essence, each party must act in a way that gives due consideration to the legitimate interests of the other. The court in *Gugliotto v Commercial Union Assurance Co of Australia*,<sup>826</sup> held that the insured must not provide false information to, or withhold relevant information from, the insurer. The duty is further described by Fred Hawke who states that,

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<sup>821</sup> See Lord Mansfield in *Carter v. Boehm* (1766) 97 E.R. 1162; see also *Banque Financière de la Cité SA v. Westgate Ins. Co. Ltd* [1987] 2 All E.R. 923; [1989] 2 All E.R. 952, CA; [1990] 2 All E.R. 947 (HL).

<sup>822</sup> Law Commission and Scottish Law Commission, *The Insured's Post-Contract Duty of Good Faith* (Issues Paper 7, July 2010) para 7.24

<sup>823</sup> *ibid* paras 4.81, 7.15.

<sup>824</sup> *Black King Shipping Corporation v Massie; The Litsion Pride* [1985]1 Lloyd's rep 437, 518-519.

<sup>825</sup> (2007) 237 ALR 512; [2007] HCA 38; BC200707216.

<sup>826</sup> (1992) 15 MVR 463; (1992) 7 ANZ Ins Cas 61-104; see, *New Zealand Insurance Co Ltd v Forbes* (1988) 5 ANZ Ins Cas 60-871.

What utmost good faith essentially requires is that each party demonstrate an awareness of and positive commitment to the other party's reasonable expectations under the contract and, more particularly, refrain from exploiting any advantage, any position of power, influence or discretion, whether conferred by the terms of the contract itself or by the nature of the relationship, in order to avoid the anticipated costs of performing contractual obligations, to the detriment of the other party...utmost good faith can be seen as simply a form of commercial morality'.<sup>827</sup>

Matthew Ellis commented that 'while the contract is on foot, the insured must ensure that it does not act in a way that prejudices the insurer's position in respect of the claim'.<sup>828</sup> The duty also requires the insured to make 'full disclosure of the circumstances of the case'.<sup>829</sup> The insured is also prohibited from making any fraudulent claims by virtue of section 56 of the 1984 Act. The section explicitly prohibits such acts by allowing the insurer to refuse the 'payment of the claim'. The section, however, does not allow the insurer to avoid the contract for the fraudulent claim.

### 6.3.5 Further Analysis and Recommendation

The above analysis made it clear that the mere duty not to make fraudulent claim is not sufficient to satisfy the demand of 'utmost good faith'. It demands an ongoing duty which should be maintained as soon as the circumstances require<sup>830</sup> and its nature shall depend on that particular act that may meet the necessity of such circumstances.<sup>831</sup> In every action the actor must have the 'utmost good faith'. This concept has been accepted by the courts and academics of Australia. However, the 1984 Act left the duty for the court to define according to the circumstances.

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<sup>827</sup> F Hawke, 'Utmost Good Faith -- What does it really mean?' (1994) 6(2) ILJ 91, 141-142.

<sup>828</sup> 'Utmost good faith: The scope and application of s 13 of the Insurance Contracts Act in the wake of *CGU v AMP*' (2009) 20 ILJ 92, 108; See, R Loo, 'The duty of utmost good faith — is the duty and expanding?' (May 2001) Allens Arthur Robinson Insurance and Reinsurance Focus, <<http://www.aar.com.au/pubs/insur/inmay01a.htm>> accessed 2nd November 2010; C O'Neill, 'A pot of gold? The unfinished story of utmost good faith and the Insurance Contracts Act' (2008) 19 ILJ 245

<sup>829</sup> *Shepherd v Chewter* (1808) 1 Camp 274, 275, (Lord Ellenborough) (hull); see also, *Action Scaffolding Ltd v AMP Fire Ins & Gen Ins Co* (1990) 6 ANZ Ins Cases, No 60-970 (motor).

<sup>830</sup> Andre Naidoo and David Oughton 'The confused post-formation duty of good faith in insurance law: from refinement to fragmentation to elimination?' (2005) JBL 346, 349.

<sup>831</sup> Professor Malcolm Clarke said in *The Law of Insurance Contracts* ((6<sup>th</sup> edn, Informa 2009), para 27-1A1, that the duty applies when the insured claims insurance money; he must make 'full disclosure of the circumstances of the case'.

As Hopkins states, ‘while the duty of utmost good faith is said to be paramount, the precise content of the duty remains elusive’.<sup>832</sup> A party needs to know his part of the duty so as to act adequately. If he is unclear about his duty, he may do wrong causing difficulties to the other party of the contract. Consequently, the duty under the term ‘utmost good faith’ has to be adequate and clear. The duty of the claim stage starts as soon as the peril occurs. The court in *Agapitos v Agnew*,<sup>833</sup> divided this duty into two parts – device and claim. The ‘device’ was explained by Mance LJ in *Agapitos v Agnew*,<sup>834</sup> that it is ‘used if the insured believes that he has suffered the loss claimed, but seeks to improve or embellish the facts surrounding the claim, by some lie’.<sup>835</sup> He recommended to ‘treat the use of a fraudulent device as a sub-species of making a fraudulent claim’.<sup>836</sup> To be relevant to the claim, the device must be, a ‘lie, directly related to the claim to which the fraudulent device relates which is intended to improve the insured’s prospects of obtaining a settlement or winning the case’.<sup>837</sup> Here the key factor is that a fraudulent device would not be an actionable fraud if it has no objective impact on the insured’s prospects of success. Mance LJ put it in a question, would it ‘sensibly’ have ‘any significant impact’ on the insurer or judge?<sup>838</sup> If so, forging an invoice or letter should be treated as a fraud.

The division made between the ‘device’ and the ‘claim’ created the scope of development of the duty of insured during the claim stage. However, the aforementioned explanation of the term ‘device’ given by Mance LJ is incomplete for the following reasons:

- 1) Imagine, that the house of the insured is burgled, but he has intentionally delayed in making a claim so as to let some of the important evidence disappear. Such intentional delay can be termed as ‘fraudulent’ and as such is breach of utmost good faith. Nevertheless, this would not be a ‘device’ within the abovementioned explanation.

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<sup>832</sup> Peter Hopkins ‘*AMPFP v CGU –Utmost Good Faith under section 13, the principle in Rocco Pezzano and the ‘prudent uninsured’. What does it all mean and where to from here?’* (2007)18 ILJ 1, 15

<sup>833</sup> [2002] EWCA Civ 247, [2003] Q.B. 556.

<sup>834</sup> *ibid.*

<sup>835</sup> *ibid* [30].

<sup>836</sup> *ibid* [45].

<sup>837</sup> *ibid* [45].

<sup>838</sup> *ibid* [38].

- 2) While the insurer is investigating the facts causing the peril, the insured fails to actively cooperate, making it difficult, time-consuming and expensive for the insurer to complete the investigation adequately. Such approaches of the insured would go against the rule of 'utmost good faith' as analysed above. However, this would also not be a 'device' within Mance LJ's explanation.
- 3) When making the claim, the insured knew that the insurer would want to know some facts in assessing the claim, but he has not disclosed them. The aforementioned explanation of 'device' also fails to include such non-disclosure.
- 4) During the investigation the insured recognises that the investigator fails to identify some facts or evidence that would cause negative effects on his claim, but remained silent. Such omission or duty to disclose is also not a 'device' within the aforementioned explanation.

It becomes apparent that the explanation of the 'device' is narrow and the duty related to it is very limited. A wider definition of the term 'device' should solve the problem related to the duty of utmost good faith. The author, therefore, recommends that *the 'device' is an act or omission that has direct effects on the claim. This device shall be actionable if it is material, which has to be proved by the insurer on balance of probability. A device is material where it substantially, not trivially, affects the investigation and assessment of the claim.*<sup>839</sup> The court on the facts of the case would determine the matter of substantiality. *The duty of the insured is to handle the devices with utmost good faith like a reasonable insured in his position would have dealt with considering the reciprocal duty, to act with utmost good faith, to the insurer.*

Such wider duty should benefit both the insured and insurer by saving money and time through faster and more effective investigation. This duty shall require the insured to disclose any material fact that has a direct effect on the claim meaning that the insurer can, in many cases avoid unnecessary investigations. For example, where the claim is small and the

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<sup>839</sup> In a case brought to FOS, Mr H was a self-employed plumber. In January he made a claim for burglary, which was duly paid. In May, his van was broken into and his tools were stolen. The loss adjusters insisted that he provide receipts for every item. He could not find receipts, and he asked a friend to fake one for him. When the insurers discovered this, they attempted to avoid the policy and demand repayment of the previous claim. The Ombudsman was not convinced that the forgery amounted to fraud. The policy did not cover work tools, and therefore their value was irrelevant to the claim. Insurance fraud: case studies *Ombudsman News*, (Issue 42, December 2004/January 2005).



insured has disclosed all the facts including the one that may have negative effects on his claim, the insurer may avoid an unnecessary investigation. There can be another example, where the insured is a valued consumer of the insurer for 10 years and on every occasion the insurer has found him honest in performing his duty of utmost good faith. The insurer may assess his claim by relying on his disclosure avoiding an investigation leading to saving of money and time for both parties. In summary, this duty should clarify the parties what they need to do during the claim procedure and also should create a friendly environment of cooperation between the parties, as intended by Lord Mansfield.<sup>840</sup>

The second part of the duty relates to the 'claim' itself. The courts have applied the common law duty of not to make fraudulent claim. However, a negligent exaggeration of a claim may also cause a breach of the reciprocal duty to act with utmost good faith. For example, a policy states that the insurer shall pay for the replacement of the goods insured. After the peril has occurred, the insured has checked the current price of the goods in one supplier and made the claim accordingly without comparing the price with other suppliers. Whereas if the insured was purchasing replacement goods with his own money, he would have sought the lowest price possible. Hence, the insured has breached his duty to act with utmost good faith, but the current law fails to cover such acts that contravene the theory of utmost good faith. The author, therefore, recommends that *the insured's duty is to act with utmost good faith in making the claim as a reasonable insured in his position would do considering the reciprocal duty to the insurer.*

Whilst the duty is specified, the next question is how it should be applied. The Law Commission criticised the Australian approach of the application of the duty by way of an implied term in the contract because that would create uncertainty, in a similar manner to the 'express contract terms requiring parties to act in good faith [which] have been held unenforceable for uncertainty in both the English and the Scottish courts.'<sup>841</sup> Further, such implied term can be excluded by express agreement in English law.<sup>842</sup> The Law Commission,

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<sup>840</sup> (1766) 97 E.R. 1162.

<sup>841</sup> The Law Commission and The Scottish Law Commission *Damages for Late Payment and the Insurer's Duty of Good Faith* (Issues Paper 6, 2010) para 4.50.

<sup>842</sup> *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827. However, the express terms excluding implied terms are construed narrowly. In the case of exclusions for negligence, the clause must pass the exacting standards set out in *Canada Steamship Lines Ltd v The King* [1952] AC 192. Scots law has reached a similar conclusion in *North of Scotland Hydro Electric Board v D & R Taylor* 1956 SC 1; *Smith v UMB Chrysler (Scotland) Ltd* 1978 SC (HL) 1.

therefore, opposes the application of the duty through an implied term. The duty, however, can be applied through statutory rules if reasonable remedy is imposed. There is the scope to impose a reasonable remedy (this will be discussed in Chapter 7) and as such the author is of the view that the duty should be applied through statutory rules.

### 6.3.6 Duty under Shariah Principles

It has already been clarified that Islamic law is in favour of a reciprocal duty. The current approach of English courts, that the duty not to make fraudulent claim is also accepted by the Islamic law. As Ibn Abi Awfa said

قَالَ ابْنُ أَبِي أَوْفَى النَّاجِشُ أَكِلُ رَبِّا خَائِنٌ وَهُوَ خِدَاعٌ بَاطِلٌ لَا يَجِلُّ قَالَ النَّبِيُّ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ الْخَدِيعَةُ فِي النَّارِ وَمَنْ عَمِلَ عَمَلًا لَيْسَ عَلَيْهِ أَمْرُنَا فَهُوَ رَدٌّ

*One who practices Najsh (a kind of fraud) is a riba-eating, traitor. And such a practice is a false trick which is forbidden, and the Prophet (S.A.W) said: Deception would lead to the hell and whoever does a deed which is not in accord with our tradition, then that deed will not be accepted.*<sup>843</sup>

However, the mere duty of not making fraudulent claim is not sufficient to fulfill the obligations of Islamic law regarding business transactions. The obligation to observe utmost good faith is a major condition of a contract. As Allah (SWT) says

يَأَيُّهَا الَّذِينَ آمَنُوا لَا تَأْكُلُوا أَمْوَالَكُم بَيْنَكُم بِالْبَاطِلِ إِلَّا أَنْتُمْ تَجَارَةٌ عَنِ تَرَاضٍ مِنْكُمْ

*O you who believe, eat not up your property among your selves in vanities, but let there be amongst you traffic and trade by mutual goodwill.*<sup>844</sup>

Here Allah (SWT) emphasised the point of *mutual goodwill* that can be termed as ‘utmost good faith’. An honest mistake of a party does not go against the rule of goodwill, but negligence may contravene the rule. The terms ‘mutual goodwill’ or ‘utmost good faith’ require the insured to act in a way that does not deprive the other party to the contract, in this case the insurer. As it is said in the Holy Quran

<sup>843</sup> Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari*, كِتَابُ الْبُيُوعِ - بَابُ النَّجْشِ وَمَنْ قَالَ لَا يَجُوزُ ذَلِكَ الْبَيْعُ, M Muhsin Khan (tr), *Sahih Bukhari*, Kitab al-Buyu', Vol. 34, chapter 61, p181.

<sup>844</sup> *The Holy Quran*, 4:29.

ويقوم أوفوا المكيال والميزان بالقسط، ولا تبخسوا الناس أشياءهم ولا تعثوا في الأرض مفسدين

*And O my people, give full measure and weight in justice and do not deprive the people of their due and do not commit abuse on the earth, spreading corruption.*<sup>845</sup>

In an insurance case the insurer would suffer loss if the insured acts negligently or fraudulently causing the insurer to pay more than the insured should get or causing him extra costs for an investigation. For example, if the insured negligently demanded more than his actual loss and the insurer pays him on that claim, the insurer is deprived of the that extra amount. If the insurer appoints someone to investigate the accuracy of the claim, he incurs cost in doing so, and as such is deprived of the money that spends on the investigation caused by the insured's negligence.<sup>846</sup> The transaction is further required to be just and fair.<sup>847</sup> Whether an insured is acting in a just and fair way can be decided by considering the action of a reasonable person in his position. Further to that, 'the [insurer] should not be taken unawares lest the [insured] should take undue advantage of his ignorance of the conditions and prices prevailing in the market'.<sup>848</sup> The duties that the author has recommended for English law by dividing its nature into two parts is fair for both parties, logical for the practice of insurance and so it meets the requirements of Shariah principles. Hence, the application of Islamic policies should not breach Shariah principles in this regard if English insurance law adopts the author's recommended duty. Until the English law adopts the duty, the Islamic insurer should incorporate adequate terms in the contract to give effect to the recommended duty so as to make the contract Shariah compliant.

## **6.4 Duty of the Insurer at the Third Stage of the Contract – The Claim Stage**

### **6.4.1 Duty under Current English Insurance Law**

Under section 17, an insurer has the duty to observe utmost when handling claims from the insured. Although the duty exists in theory, its extent has not been determined by any court. Whereas, its extent at this stage of the contract is clear, an insurer has to handle claims fairly, honestly and paying claims in reasonable time. Yet the courts are reluctant to take these

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<sup>845</sup> ibid 11:85

<sup>846</sup> If the insurer investigates for his own satisfaction then the insured shall have no liability to it. His duty is only to make sure that his negligence is not costing the insurer.

<sup>847</sup> Abdul Hamid Siddiqi (tr), *Sahih Muslim* (SH. Muhammad Ashraf, Kashmiri Bazar, Lahore, Pakistan 1973) Vol III, 792.

<sup>848</sup> ibid 793.

duties out of the display cabinet where everyone can view them, but not use them. As Rix LJ commented ‘this is another important issue which I do not think it would be right to ignore, but which I would not wish to decide’.<sup>849</sup> The possible reason for not wishing to decide guidelines is the remedy for breach of this duty, which eventually goes against the insured. In consequence, this area of law remains undeveloped. The proof of this non-development can be found in the words of Clarke LJ who said in *Drake Insurance plc v Provident Insurance plc* that ‘there is at present (so far as I am aware) no authority for the proposition that an insurer owes the insured a duty to take reasonable care to make appropriate inquiries before avoiding the policy’.<sup>850</sup>

In several cases, the courts are in a dilemma and are uncertain about the nature of the duty of the insurer at the claim stage. In *Insurance Corporation of the Channel Islands Ltd and Another v McHugh and Royal Hotel Ltd*,<sup>851</sup> the policyholder claimed that the insurer had the implied term duty to negotiate and pay insurance money with reasonable diligence and due expedition. Mance J rejected the claim, partly on the grounds that the implied term suggested by the insured fails to satisfy the prerequisites for an implied term. He said ‘if any such term existed at all, it would, *presumably*, have to be mutual’ (emphasis added).<sup>852</sup> The words ‘if’ and ‘presumably’ show how the judge is unsure whether there should be any implied term in an insurance contract or not.<sup>853</sup> If it exists, he says, ‘the reasonableness of each party’s conduct would, if necessary, be susceptible of review at each point’.<sup>854</sup> Longmore LJ speaking extrajudicially stated in a lecture that ‘the courts have set their face against there being an implied term of an insurance contract that valid claims will be met’.<sup>855</sup> On the other hand, in *The Star Sea*,<sup>856</sup> Lord Hobhouse, with whom Lord Steyn and Lord Hoffmann agreed, considered the duty of good faith as part of the contract.<sup>857</sup> As he said once the parties are in a contractual relationship, ‘the source of their obligations the one to the other is the contract (although the contract is not necessarily conclusive)’, and that a ‘coherent scheme can be

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<sup>849</sup> *Drake Insurance plc v Provident Insurance plc* [2003] EWCA Civ 1834; [2004]1 Lloyd’s Rep 268 [79].

<sup>850</sup> [2003] EWCA Civ 1834; [2004]1 Lloyd’s Rep 268 [145]

<sup>851</sup> [1997] LRLR 94.

<sup>852</sup> *ibid* 136 (emphasis added).

<sup>853</sup> See, Malcolm Clarke, ‘Compensation for failure to pay money due: a ‘blot on English common law jurisprudence’ partly remove’ (2008) JBL 291, 297.

<sup>854</sup> [1997] LRLR 94, 136.

<sup>855</sup> Sir Andrew Longmore, ‘An Insurance Contracts Act for a new century?’ (British Insurance Law Association Trust, 5 March 2001).

<sup>856</sup> *Manifest Shipping Co Ltd v Uni-Polaris Shipping Co Ltd* [2003] 1 AC 469; See, *Banque Keyser Ullmann SA v Skandia (UK) Insurance Co Ltd* [1990]1 QB 665, 777 (Slade LJ)

<sup>857</sup> *ibid* [50].

achieved by distinguishing a lack of good faith which is material to the making of the contract'. The former 'derives from the requirement of the law which pre-exists the contract' and the latter 'can derive from express or implied terms of the contract'.<sup>858</sup> In this case Lord Clyde considered the duty as flexible and variable according to the context.<sup>859</sup> Nevertheless, the Court of Appeal in *Drake Insurance Plc v Provident Insurance Plc*,<sup>860</sup> considered the duty as arising under section 17 and not as contractual term. Although the court considered this duty under section 17, it did not provide the remedy that the section requires. The dilemma of the court can be found in *Eagle Star v Cresswell* where Rix LJ said that if the duty could not be implied, then it may be inherent from the mutual obligation of good faith.<sup>861</sup> The courts are also in dilemma regarding the nature of the duty. Mance J took the view that the duty of the insurer at this stage is one of 'good faith' rather than 'utmost good faith'.<sup>862</sup> The later courts did not welcome this approach. For example, in *Drake Insurance Plc v Provident Insurance Plc*,<sup>863</sup> the Court of Appeal considered the duty as 'utmost good faith'. But was divided over the extent of that duty. A majority held that, 'there is at present no authority for the proposition that an insurer owes the insured a duty to take reasonable care to make appropriate inquiries before avoiding the policy,'<sup>864</sup> whereas Pill LJ, held that 'a failure to make any inquiry of the insured before taking the drastic step of avoiding the policy was...a breach by the insurer of the duty of good faith'.<sup>865</sup> The Court of Appeal, however, in this case held that the avoidance of a claim relying on a fact that is immaterial is itself a breach of duty.

The debate can also be found among academics. Malcolm A Clarke considers the duty at the claim stage as a 'duty of co-operation'. He says that 'when a claim is made under a policy, the relationship between the parties to the contract of insurance enters a new phase, the nature of which requires co-operation on each side. Duties of co-operation are usually express terms

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<sup>858</sup> *ibid* [52].

<sup>859</sup> *ibid* [7], [54] (Lord Hobhouse).

<sup>860</sup> [2003] EWCA Civ 1834; [2004] Q.B. 601.

<sup>861</sup> [2004] 1 C.L.C. 926, 960.

<sup>862</sup> *The Standard Steamship Owners' Protection and Indemnity Association (Bermuda) Ltd v Oceanfast Shipping Ltd (The Ainikolas I)* (QBD (Comm Ct) Lexis Transcript, 7 March 1996) (Mance J). The case is referred to in A Naidoo & D Oughton, 'The confused post-formation duty of good faith in insurance law: from refinement to fragmentation to elimination?' (2005) JBL 346, 359.

<sup>863</sup> [2003] EWCA Civ 1834; [2004] Q.B. 601 [19] (Rix LJ), [161] [164] [177] (Phill LJ). See, *Manifest Shipping Co Ltd v Uni-Polaris Shipping Co Ltd* [2003] 1 AC 469 [7] (Lord Clyde);

<sup>864</sup> *ibid* [145] (Clarke LJ).

<sup>865</sup> *ibid* [177].

of the policy, but if not, they may also be implied'.<sup>866</sup> He referred to the case *Gan v Tai Ping (Nos 2 & 3)*,<sup>867</sup> a reinsurance case, where the express terms of the contract included the duty of co-operation. These terms, however, required the reinsured to co-operate. As such the question of co-operation from the reinsurer's side remain elusive. However, Mance LJ, with whom Latham LJ agreed, held that, where the reinsurer is 'entitled to exercise his own judgment', consent should not be withheld 'arbitrarily',<sup>868</sup> and that 'any withholding of approval by reinsurers should take place in good faith after consideration of and on the basis of the facts giving rise to a particular claim and not with reference to considerations wholly extraneous to the subject matter of the particular reinsurance'.<sup>869</sup> Such duty, in his view, did not arise from 'any principles or considerations special to the law of insurance' but 'from the nature and purpose of the relevant contractual provision'.<sup>870</sup> Malcolm A Clarke considers these provisions as a 'co-operation clause'.<sup>871</sup>

The theory of the relationship as one of co-operation has been heavily opposed by Eggers, Picken and Foss. They state that 'the duty of good faith does not exact a formal duty on the parties to co-operate, with the consequence that a breach of his obligation would entitle the innocent party to avoid the contract'.<sup>872</sup> They emphasised the point that 'there is no authority<sup>873</sup> in English law in favour of obliging the parties to co-operate or which recognises such a result'.<sup>874</sup>

Out of these two groups of academics, Malcolm A Clarke is of the view that a breach of the co-operation clause shall defeat the claim not the contract, whereas the second group believe that the duty at this stage operates under section 17, meaning that a breach of the duty shall entitle the innocent party to avoid the contract *ab initio* which is termed as draconian. According to the latter group if the duty of co-operation is seen as the duty of good faith

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<sup>866</sup> Malcolm A. Clarke, *The Law of Insurance Contracts* (6<sup>th</sup> edn, Informa 2009) para 27-4A.

<sup>867</sup> [2001] Lloyd's Rep IR 667 (CA-re).

<sup>868</sup> *ibid* [73], [74].

<sup>869</sup> *ibid* [67], see also [76].

<sup>870</sup> *ibid* [68].

<sup>871</sup> Malcolm A. Clarke, *The Law of Insurance Contracts* (6<sup>th</sup> edn, Informa 2009) para 27-4A2.

<sup>872</sup> Peter Macdonald Eggers, Simon Picken and Patrick Foss *Good Faith and Insurance Contract* (2<sup>nd</sup> edn, LLP 2004) 299.

<sup>873</sup> There may be contrary argument based on the following authorities: *Liberian Insurance Agency Inc v Mosse* [1977] 2 Lloyd's Rep 560, 570 (Donaldson J); *Insurance Corporation of the Channel Islands Ltd v McHugh* [1997] LRLR 94, 136-138 (Mance J). *cf Carter v Boehm* (1766) 97 ER 1162, 1166 (Lord Mansfield), where the insurer had been to the court of equity to assist in his investigation of the claim.

<sup>874</sup> Peter Macdonald Eggers, Simon Picken and Patrick Foss *Good Faith and Insurance Contract* (2<sup>nd</sup> edn, LLP 2004) 299.

under section 17, then the breach of the duty even by mistake shall impose the draconian remedy, which is an unacceptable state of affairs.<sup>875</sup> These two schools of thought consider the matter from two viewpoints. Malcolm A Clarke considers the importance of the application of the duty and as such suggested the wider duty and minimised the seriousness of the remedy by recommending it to be part of the contractual terms, whereas Eggers, Picken and Foss considered the seriousness of the remedy offered by section 17 meaning that they prefer a narrower duty.

However, there are two propositions that have not yet been doubted by any courts or academics, that ‘utmost good faith is a principle of fair dealing’.<sup>876</sup> This proposition has been applied by the Court of Appeal in *Drake Insurance Plc v Provident Insurance Plc*.<sup>877</sup> Rix LJ said that the content of the duty should be decided on the basis ‘of proportionality implicit in fair dealing’.<sup>878</sup> The other proposition is that avoidance by the insurer in certain circumstances can itself breach the duty of utmost good faith. Lord Hobhouse said in *The Star Sear*<sup>879</sup> that ‘the courts have consistently set their face against allowing the assured’s duty of good faith to be used by the insurer as an instrument for enabling the insurer himself to act in bad faith’.<sup>880</sup> This proposition has been applied in *Drake Insurance Plc v Provident Insurance Plc*.<sup>881</sup> There is another proposition that has been created by Lord Goff for indemnity insurance, which is doubted by the Law Commission but not by any court.<sup>882</sup> Lord Goff believed that the insurer’s duty is to hold the insured harmless against the liability or loss insured against.<sup>883</sup> This was applied by Mance J in *Insurance Corporation of the Channel Islands Ltd and Another v McHugh and Royal Hotel Limited*<sup>884</sup>

According to above discussion it is apparent that the debate is on several grounds. Whether the duty is part of the contract or part of section 17, what is the content of the duty? Is the duty to observe ‘utmost good faith’ or only ‘good faith’? And finally what should be the

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<sup>875</sup> *ibid* 299.

<sup>876</sup> *Manifest Shipping Co Ltd v Uni-Polaris Shipping Co Ltd* [2003] 1 AC 469 affirmed by Lord Hobhouse at [48].

<sup>877</sup> [2003] EWCA Civ 1834; [2004] Q.B. 601 [19] (Rix LJ), [161], [164], [177] (Phill LJ). See, *Manifest Shipping Co Ltd v Uni-Polaris Shipping Co Ltd* [2003] 1 AC 469, [7] (Lord Clyde);

<sup>878</sup> *ibid* [88], [89].

<sup>879</sup> *Manifest Shipping Co Ltd v Uni-Polaris Shipping Co Ltd* [2003] 1 AC 469; See, *Banque Keyser Ullmann SA v Skandia (UK) Insurance Co Ltd* [1990] 1 QB 665, 777, (Slade LJ).

<sup>880</sup> *ibid* [57], [79].

<sup>881</sup> [2003] EWCA Civ 1834; [2004] Q.B. 601.

<sup>882</sup> ‘Damages for Late Payment and the Insurer’s Duty of Good Faith (Issues Paper 6, 2010) paras 9.48, 9.49.

<sup>883</sup> See, *The Fantini and The Padre Island* [1991] 2 AC 1, 35 (Lord Goff).

<sup>884</sup> [1997] LRLR 94

remedy?<sup>885</sup> A list of duties can be drawn from different opinions taken by the courts on these issues:

- a) The insurer must adequately investigate before taking the decision to avoid the contract.<sup>886</sup>
- b) While verifying the claim, the insurer shall consider the facts giving rise to the particular claims not to extraneous circumstances.<sup>887</sup>
- c) The insurer shall not delay in payment of the claim for a reason unrelated to the particular claim;<sup>888</sup>
- d) The insurer must not avoid the contract for a reason that he knows or has shut-eye knowledge that the reason is not strong enough to justify such drastic remedy.<sup>889</sup> For example in *Drake Insurance Plc v Provident Insurance Plc*,<sup>890</sup> the insurer had knowledge or shut-eye knowledge that the nondisclosure of the accident did not affect their interest due to the settlement of S's wife's accident as 'no fault'. In such circumstances the avoidance of contract itself constitutes the breach of good faith.
- e) Something less than the knowledge, such as notice of something that may happen but the insurer has no knowledge whether it has actually happened or not, imposes the duty to communicate with the insured giving him the opportunity to defend himself, and argue against the reason for which the insurer is minded to avoid the policy.<sup>891</sup>
- f) The duty of utmost good faith imposes a reciprocal duty to act with a positive mind.<sup>892</sup> For example, an insured makes a claim where he, by mistake, claims for less than he actually deserves. The insurer notices it. According to this rule the insurer should inform the insured about his right to recover the correct amount.

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<sup>885</sup> The remedy for breach of the duty shall be discussed in next chapter.

<sup>886</sup> *Drake Insurance Plc v Provident Insurance Plc* [2003] EWCA Civ 1834; [2004] Q.B. 601, [177] (Pill LJ).

<sup>887</sup> *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd* [2001] EWCA Civ 1047; [2001] CLC 1103 [76].

<sup>888</sup> *ibid* [68].

<sup>889</sup> *Drake Insurance Plc v Provident Insurance Plc* [2003] EWCA Civ 1834; [2004] Q.B. 601, [91] (Rix LJ), [144] (Clarke LJ); *Pan Atlantic Insurance v Pine Top Insurance*, [1994] 3 All E.R. 581, 623; see also A Naidoo & D Oughton, 'The confused post-formation duty of good faith in insurance law: from refinement to fragmentation to elimination?' (2005) JBL 346, 363.

<sup>890</sup> [2003] EWCA Civ 1834; [2004] Q.B. 601.

<sup>891</sup> *ibid* [92] (Rix LJ).

<sup>892</sup> *Banque Financiere de la Cite v Westgate Insurance Co Ltd*, [1987]2 WLR 1300, 1328. Although the remedy of this court was overruled by the Court of Appeal, the duty explained by this court was reiterated by the latter court. See, for instance [1990] 1 Q.B 665, 770-771. The decision in *Drake Insurance Plc v Provident Insurance Plc* [2003] EWCA Civ 1834 carries the similar approach.



- g) The duty of utmost good faith also imposes the duty to refrain from bad faith.<sup>893</sup> For example, the insurer may receive a good amount of interest or profit from the amount that he is supposed to pay if he delays to pay a week or more. This duty shall prevent him from delaying payment with bad faith.
- h) While exercising contractual rights, the insurer must act with good faith.<sup>894</sup>
- i) The insurer when seeking to terminate the contract ‘must make good his ground for bringing the contract to an end’.<sup>895</sup>
- j) In liability and property insurance the insurer must hold the insured harmless against the liability or loss insured against.<sup>896</sup>
- k) The insurer’s duty is to observe ‘good faith’ not ‘utmost good faith’.<sup>897</sup>

The duties that are identified by different courts in different cases are sufficient to bring the justice that the courts have been searching for. However, the loopholes in the Act have made it difficult for the courts to apply these duties. In such circumstances the FSA imposed the following list of duties for insurers that are similar to the list above:<sup>898</sup>

An *insurer* must:

- (1) handle claims promptly and fairly;
- (2) provide reasonable guidance to help a *policyholder* make a claim and appropriate information on its progress;
- (3) not unreasonably reject a claim (including by terminating or avoiding a *policy*); and
- (4) settle claims promptly once settlement terms are agreed.

Although these duties appear to be sufficient to bring justice among the parties, they are not capable to be applied in all insurance contracts. These rules are applicable only when the insureds take a complaint to the Financial Ombudsman Services (FOS).<sup>899</sup> Only consumers

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<sup>893</sup> See, William, J. Perry and Heidi Nash-Smith ‘*Drake v Provident’s* Effect on Insurers’ Duty of Good Faith in English Law’, (July 2005) 72(3) Defense Counsel Journal 298, 302

<sup>894</sup> *Eagle Star Insurance Co Ltd v Cresswell* [2004] EWCA Civ 602; [2004]1 CLC 926, 960 (Rix LJ).

<sup>895</sup> *Drake Insurance Plc v Provident Insurance Plc* [2003] EWCA Civ 1834; [2004] QB 601, [96] (Rix LJ)

<sup>896</sup> See, *The Fanti and The Padre Island* [1991] 2 AC 1, 35 (Lord Goff); *Insurance Corporation of the Channel Islands Ltd and Another v McHugh and Royal Hotel Limited* [1997] LRLR 94 (Mance J).

<sup>897</sup> *The Standard Steamship Owners' Protection and Indemnity Association (Bermuda) Ltd v Oceanfast Shipping Ltd (The Ainikolas I)* (QBD (Comm Ct) Lexis Transcript, 7 March 1996) (Mance J).

<sup>898</sup> ICOBS Rule para 8.1.1

<sup>899</sup> The FOS decide disputes according to what is ‘fair and reasonable in all the circumstances of the case’. They have regard to the law, but where the legal result would be unfair, they do not apply the law.

and business with a turnover less than €2 million and fewer than ten employees,<sup>900</sup> can take a complaint to the FOS.<sup>901</sup>

#### 6.4.2 Critical Analysis of English Insurance Law

The duty and remedy that are imposed by section 17 appear to be right, just and fair, but a proper analysis uncovers the problems that they cause. The section simply says that the insurer must observe utmost good faith. All courts accept that the duty of utmost good faith is applicable at the claim stage, but the content of that duty is clear to no one. The lack of clear guidelines and the draconian remedy for breach of that duty have confused the courts meaning that the case law on this issue is inconsistent.

The first issue to be considered is whether there should be duty of ‘good faith’ or ‘utmost good faith’ at the claim stage. The birth of this issue is *The Ainikolas*,<sup>902</sup> when the insured sought to argue that a mistaken claim by the insurers for payment of interest was a breach of the duty of utmost good faith. Mance J held that a mere mistake was insufficient to make the insurer liable. As such, he held that, the duty at this stage is to observe ‘good faith’ instead of ‘utmost good faith’. The possible reason for taking such an approach is that the court found that it would be unfair to make the insurer liable for an innocent mistaken act. It is apparent from this decision that if the word ‘utmost’ is omitted, the party should not be liable for innocent mistake. The Law Commission supported the omission of the word for the insurer at the claim stage referring to it as ‘confusing’.<sup>903</sup> They said that the word ‘utmost’ stretches ‘the parties’ mutual duties beyond reasonable honesty and integrity’.<sup>904</sup> Consequently, the insurer shall be liable even if he acts with honesty. The term ‘utmost good faith’ is a very wide term that imposes a reciprocal duty to act with positive mind.<sup>905</sup> No one can refuse the argument that a party needs to act with his best possible honesty in an insurance contract. If

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<sup>900</sup> FSA Handbook, DISP para 2.7.3. See, < <https://fshandbook.info/FS/glossary-html/handbook/Glossary/M?definition=G2623>> for the explanation of the micro enterprise. Accessed 17 April 2013.

<sup>901</sup> *ibid.*

<sup>902</sup> *The Standard Steamship Owners' Protection and Indemnity Association (Bermuda) Ltd v Oceanfast Shipping Ltd (The Ainikolas I)* QBD (Comm Ct) Lexis Transcript, 7 March 1996.

<sup>903</sup> *Damages for Late Payment and the Insurer's Duty of Good Faith* (Issues Paper 6, 2010) para 9.12.

<sup>904</sup> *ibid* 4.10.

<sup>905</sup> *Banque Financiere de la Cite v Westgate Insurance Co Ltd*, [1987]2 WLR 1300, 1328. Although the remedy of this court was overruled by the Court of Appeal, the duty explained by this court was reiterated by the later court. See, for instance [1990] 1 QB 665, 770-771. The decision in *Drake Insurance Plc v Provident Insurance Plc* [2003] EWCA Civ 1834 carries the similar approach.

the party makes an honest and innocent mistake, that damages the interests of the other, logic suggests that the wrongdoer should be liable to compensate the other party. It is recognised by the court in Australia that an honest mistake can also breach the duty of utmost good faith.<sup>906</sup> Consequently, making the insurer liable for innocent mistake in certain circumstances should not be unfair. Hence, the word 'utmost' is rather necessary to be applied at this stage, since the word carries the actual meaning of mutuality and fair dealing and can stop the insurer from doing something that may harm the insured.

In the Australian case of *Gutteridge v Commonwealth of Australia*,<sup>907</sup> the insured plaintiffs made a claim for indemnity against the insurer respondent following the destruction of their house by fire. The insurer delayed making a decision in respect of the claim for approximately two months, ultimately declining the claim only after the insured had commenced an application for a declaration that the insurer was obliged to make its decision forthwith. In considering the duty, Ambrose J stated:

To act 'with the utmost good faith' towards the applicants with respect to their claim under the insurance policy, the respondent was certainly required to act honestly in declining to make a decision with respect to the applicants' claim for indemnity upon the destruction of the dwelling house. While the respondent might not fail to act 'in good faith' if he acted honestly although in a blundering or careless fashion, the failure of the respondent to make and communicate within a reasonable time a decision of acceptance or rejection of the applicants' claim for indemnity by reason of negligence or unjustified and unwarrantable suspicion as to the bona fides of the applicants' claim, may constitute a failure on the part of the respondent to act towards the applicants 'with the utmost good faith' in dealing with their claim lodged on 3rd March 1993. Acting with 'utmost good faith' must involve more than merely acting honestly; otherwise, no effect is given to the word 'utmost'.<sup>908</sup>

According to this decision an insurer shall not be liable for breach of 'good faith' 'if he acted honestly although in a blundering or careless fashion'.<sup>909</sup> On the other hand, it is necessary for the interest of each party to the contract to apply 'utmost good faith' so as to make the other act with positive mind as discussed above.

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<sup>906</sup> *AMP Financial Planning Pty Ltd v CGU Insurance Ltd* (2005) 146 FCR 447, 475; 55 ACSR 305, 331; [2005] FCAFC 185; BC200506441 (Emmett J).

<sup>907</sup> Unreported, Qld SC, 25 June 1993, BC9302579 (Ambrose J).

<sup>908</sup> *ibid* (Ambrose J).

<sup>909</sup> *ibid* (Ambrose J).

Similarly if an insured makes a claim less than the actual loss and the investigator of the insurer discovers this mistake and reports it to the insurer, then according to the above discussion, utmost good faith demands that the insurer should inform the insured and increase the figure.<sup>910</sup> Here, the question is what should be the duty under the term ‘good faith’ be if this is a less duty than utmost good faith. The only possible answer would be to pay the amount that is actually claimed. This should go against the requirement of mutuality. As such the word ‘utmost’ is necessary to be applied. Further to that, the insured, at the pre-contract stage is required to disclose all the facts including ones that are detrimental to his interests. The insurer should be in a similar position at the claim stage and be required to act with utmost good faith even if that detracts his interest.

A further situation can be considered, imagine that both the insured and insurer appoint investigators and the report of the insurer’s investigator shows that the insured’s fault has caused the peril whilst no such fault is shown in the other’s report. In such case, if the insurer refuses the claim relying on his investigator’s report, the insured would be less likely to raise a claim for breach of duty of ‘good faith’ than ‘utmost good faith’ because the earlier does not require the insurer to act positively with a reciprocal mindset as opposed to the latter. The latter would require the insurer to call for a third investigator and reach a reasonable solution that is acceptable to both sides.<sup>911</sup> Hence, the application of ‘utmost good faith’ is fairer.

Further, if the duty of ‘good faith’ is applied to the insurer the same duty has to be applied to the insured under the rule of proportionality or fair dealing.<sup>912</sup> Under the mere duty of ‘good faith’ the insured shall not be required to provide positive cooperation to the investigator of the insurer, which has been claimed to be the duty at the claim stage by Malcolm A Clarke.<sup>913</sup> The lack of positive cooperation shall also undermine the real basis of the duty, which is the mutual obligation to each other. ‘Utmost good faith’ on the other hand carries all the

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<sup>910</sup> This is the duty imposed by FSA, as it says ‘provide reasonable guidance to help a *policyholder* make a claim and appropriate information on its progress’ ICOBS Rule 8.1.1

<sup>911</sup> See, *Legal and General Insurance Australia Ltd v Eather* (1986) 6 NSWLR 390, 393-394 (Kirby J). See, *Allan v National Mutual Life Association of Australasia Pty Ltd* (1993) 9 SR (WA) 68; *Giles* (1986) 4 ANZ Insurance Cases 60-751; *Tillotson v ANZ Life Assurance* (1986) 17 SR (WA) 34; James Bremen ‘Good Faith and Insurance Contracts – Obligations on Insurers’ (1999) 19 Aust Bar Rev 89, 92; K C Sutton, ‘The Duty of Utmost Good Faith -- Recent Developments’ (1994) Australian Business Law Review 22; M Fotheringham, ‘Total and Permanent Disability Policies’ (1998) 10 ILJ 42.

<sup>912</sup> *Manifest Shipping Co Ltd v Uni-Polaris Shipping Co Ltd* [2003] 1 AC 469 affirmed by Lord Hobhouse at [48]; *Drake Insurance Plc v Provident Insurance Plc* [2003] EWCA Civ 1834; [2004] QB 601 [88], [89] (Rix LJ).

<sup>913</sup> Malcolm A. Clarke, *The Law of Insurance Contracts* ((6<sup>th</sup> edn, Informa, London, 2009), para 27-4A.

necessary elements of the duty that is demanded from a party in an insurance contract. Hence, the duty of ‘utmost good faith’, instead of ‘good faith’, should be applied at the claim stage.

### 6.4.3 Duty in the Eye of the Law Commission

The Law Commission is against the application of the duty under contractual terms.<sup>914</sup> They prefer it to be based on ‘good faith’, not ‘utmost good faith’ as discussed above. There are two main categories of duties that they have identified, the duty to observe good faith.<sup>915</sup> They consider this to be non-excludable. The second category, is the strict liability of paying valid claims within a reasonable time.<sup>916</sup> This duty is strict in the sense that the insurer shall be liable for breach of this duty even if he refuses for a reasonable ground but later loses the case. They offered an objective test for determining the length of the time that is reasonable for the payment.<sup>917</sup> This ‘strict liability’ shall be read subject to the express terms of the contract. They prefer this duty to be applied by the Courts, instead of by legislation, overturning the decision in *Sprung v Royal Insurance (UK) Ltd.*<sup>918</sup>

The Law Commission further provided guidelines for the contents of good faith, whilst conceding that an exhaustive list is impossible. According to their guidelines an insurer shall,

- not act fraudulently or dishonestly;<sup>919</sup>
- not continue to avoid a policy or to repudiate a claim relying upon allegations that have been shown to be incorrect;<sup>920</sup>
- not be seriously incompetent in handling claim;<sup>921</sup>
- make proper enquiry after receiving a claim and before refusing it;<sup>922</sup>
- not act arbitrarily;<sup>923</sup>
- not take wholly extraneous circumstances into account;<sup>924</sup>
- not reject claims unreasonably;<sup>925</sup>
- settle claims promptly once settlement is agreed;<sup>926</sup>

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<sup>914</sup> *Damages for Late Payment and the Insurer’s Duty of Good Faith* (Issues Paper 6, 2010) para S.22.

<sup>915</sup> *ibid* para 9.3.

<sup>916</sup> *ibid* para 9.4.

<sup>917</sup> *ibid* para 9.4.

<sup>918</sup> [1999] 1 Lloyd’s Rep IR 111; [1997] CLC 70.

<sup>919</sup> *Damages for Late Payment and the Insurer’s Duty of Good Faith* (Issues Paper 6, 2010) para 9.16.

<sup>920</sup> *ibid* para 9.16.

<sup>921</sup> *ibid* para 9.16.

<sup>922</sup> *ibid* para 9.17.

<sup>923</sup> *ibid* para 9.17.

<sup>924</sup> *ibid* para 9.17.

<sup>925</sup> *ibid* para 9.17.

- act on the express terms of the contract with good faith;<sup>927</sup>
- provide reasons for refusing a claim;<sup>928</sup>
- pay the claim (or perform services) in the circumstances specified in the contract instead of current duty of holding the insured harmless.<sup>929</sup>

#### 6.4.4 The Legal Position in Australia

The duty of the insurer at this stage exists as an implied term of the contract by virtue of section 13 of Insurance Contracts Act 1984. Sections 12 and 14 made the duty paramount. All these sections have been analysed above. However, at this stage the duty related to the insurer demands further analysis. It has been stated above that the term ‘utmost good faith’ is included in the section but not defined. Callan O’Neill commented that the duty at this stage is variable in nature, which is ‘better described than defined’.<sup>930</sup> Fred Hawke states that the duty requires ‘each party to demonstrate an awareness of and positive commitment to the other party’s reasonable expectations’ and ‘refrain from exploiting any advantage, any position of power, influence or discretion to the detriment of the party’. The duty is seen as ‘simply a form of commercial morality’.<sup>931</sup> The commercial morality or fair dealing creates a relationship of trust where the insured trusts that the insurer shall provide the protection that he promised under the policy if and when required.<sup>932</sup>

The nature of the duty is derived from a body of case law that relates to *uberrimae fides*. In *Edwards v Hunter Valley Co-Op Co Dairy Ltd*, the court held that the insurer needs to consider the interests of the claimant when making determinations under the policy.<sup>933</sup> The court in *Ivkovic v Australian Casualty and Life Ltd*,<sup>934</sup> held that

There is undeniably something patently invidious about a contractual provision which makes any insured's qualification for benefit depend entirely upon the formation of a

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<sup>926</sup> *ibid* para 9.17.

<sup>927</sup> *ibid* para 9.20.

<sup>928</sup> *ibid* paras 9.17, 9.24.

<sup>929</sup> *ibid* paras 9.48, 9.49.

<sup>930</sup> Callan O’Neill ‘A pot of gold? The unfinished story of utmost good faith and the Insurance Contracts Act’ (2008) 19 ILJ 245, 249. See, S Drummond, ‘Unconscionable conduct and utmost good faith’ (2003) 14 ILJ 1, 3; K Godfrey, ‘The duty of utmost good faith -- The great unknown of modern insurance law’ (2002) 14 ILJ 1, 2.

<sup>931</sup> ‘Utmost Good Faith -- What does it really mean?’ (1994) 6(2) ILJ 91, 141-2.

<sup>932</sup> Matthew Ellis ‘Utmost good faith: The scope and application of s13 of the Insurance Contracts Act in the wake of *CGU v AMP*’ (2009) 20 ILJ 92, 92.

<sup>933</sup> (1992) Insurance Cases 61-113 at 77-536.

<sup>934</sup> *Ivkovic v Australian Casualty and Life Ltd* (1994) 10 SR (WA) 325, 345.

subjective opinion by the insurer in circumstances in which that opinion will directly affect both the interests of the insurer and the insured. I accept that the duty to act reasonably imposed on the insurer by such a provision does encompass a duty to act in good faith and deal fairly with the insured.

In *Moss v Sun Alliance Australia Ltd*, the Supreme Court of South Australia held that the utmost good faith requires ‘prompt admission of liability to meet a sound claim’ and also ‘prompt payment’.<sup>935</sup> In *Distillers Company Bio-chemicals (Australia) Pty Ltd v Ajax Insurance Company Ltd* Stephen J held that the insurer must exercise his obligation or discretion under the contract in good faith ‘having regard to the interests of the insured as well as to its own’.<sup>936</sup> He also said that ‘in the exercise of its power to withhold consent, the insurer must not have regard to considerations extraneous to the policy of indemnity’.<sup>937</sup> The insurer is also under the duty to provide reasons for a decision on indemnity.<sup>938</sup> Section 14 imposes further obligation on the insurer not to rely on ambiguous provisions of the contract to the detriment of the insured,<sup>939</sup> or a term placed in the policy by error.<sup>940</sup> This imposes the reciprocal duty to act with positive mind. Owen J in the *WA decision of Kelly v New Zealand Insurance Co Ltd*, suggested that a breach of the duty of utmost good faith may occur where there has been ‘dishonest, capricious or unreasonable conduct’.<sup>941</sup> The Full Court of the Federal Court has since stated that dishonesty is not the only conduct that amounts to a breach of the duty of utmost good faith, nor is dishonesty a prerequisite for a breach of the duty.<sup>942</sup> Callinan and Heydon JJ said in *CGU Insurance Ltd v AMP Financial Planning Pty Ltd*,<sup>943</sup> that ‘utmost good faith will usually require something more than passivity: it will

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<sup>935</sup> (1990) 55 SASR 145; 93 ALR 592; see *CGU Insurance Ltd v AMP Financial Planning Pty Ltd* (2007) 235 CLR 1; 237 ALR 420; 81 ALJR 1551; [2007] HCA 36; BC200707214 at [139] (Kirby J); *Gutteridge v Commonwealth of Australia*, Unreported, Supreme Court of Queensland, 25 June 1993, 12-13 (Ambrose J).

<sup>936</sup> (1974) 2 ALR 321, 341, 344. See, *Gordon v Nationwide Mutual Insurance Co* (1972) 30 NY (2d) 427; *Alcatel Australia Ltd v Scarcella* (1998) 44 NSWLR 349; *Cf Hughes Aircraft Systems v Airservices Australia* (1997) 146 ALR 1; *Distillers Co Biochemicals (Australia) Pty Ltd v Ajax Insurance Co* (1974) 130 CLR 1, 31.

<sup>937</sup> *ibid* 341. This decision has been approved by Gleeson CJ and Crennan J in *CGU Insurance Ltd v AMP Financial Planning Pty Ltd* (2007) 235 CLR 1; 237 ALR 420; 81 ALJR 1551; [2007] HCA 36; BC200707214.

<sup>938</sup> *RAF England v Zurich Australian Insurance Ltd* (unreported, Adelaide DC, Kitchen J, 30 July 1991).

<sup>939</sup> *Hammer Waste Pty Ltd v Mercantile Mutual Ltd* [2002] NSWSC 1006; BC200206430.

<sup>940</sup> *Baradom Contracting Pty Ltd (in liq)-- by its official liquidator Andrew v GIO General Ltd* (unreported, NSW SC, 13 June 1996, BC9602621).

<sup>941</sup> (1993) 7 ANZ Ins Cas 61-197; BC9301461, 78, 258. See also, *Gutteridge v Commonwealth of Australia* Unreported, Qld SC, (Ambrose J) 25 June 1993, BC9302579. *CIC Insurance Ltd v Bankstown Football Club Ltd* (1997) 187 C.L.R. 384, 401-402.

<sup>942</sup> *AMP Financial Planning Pty Ltd v CGU Insurance Ltd* (2005) 146 FCR 447, 475; 55 ACSR 305, 331; [2005] FCAFC 185; BC200506441 (Emmett J).

<sup>943</sup> (2007) 235 CLR 1; 237 ALR 420; 81 ALJR 1551; [2007] HCA 36; BC200707214. See also, Peter Hopkins ‘AMPFP v CGU –Utmost Good Faith under section 13, the principle in *Rocco Pezzano* and the ‘prudent uninsured’. What does it all mean and where to from here?’ (2007)18 ILJ 1, 20

usually require affirmative or positive action on the part of a person owing a duty of it'.<sup>944</sup> The effect of this can be found in the Total and Permanent Disablement policies where the insurers are under the duty not to deny claims merely on the basis that it is possible for the insured to return to any occupation other than the one that his career is supposed to be for. Furthermore, should there be two different medical opinions, the insurer's duty is to look for the third one.<sup>945</sup>

In conclusion, the 1984 Act and the courts of Australia imposed the duty on the insurer at the claim stage in the way that 'utmost good faith' is supposed to be imposed. It has been analysed above that the duty of 'utmost good faith' requires some positive act with reciprocal mind. When the duty is on the insurer, he has to consider the interest of the insured in his best possible way and vice versa, where the insured's expert's report contradicts to that of the insurer, the insurer has to rely on the third one. The third expert should be selected by both parties' agreement. James Bremen commented that the 'court has provided clear statements that the duty requires parties to observe the spirit of the obligation and to adhere to broad standards of fairness even though the duty itself has not been defined'.<sup>946</sup> In respect of the management of claims, the signatory insurers now advise their insureds that they will,

- i) Decide whether to accept or reject the claim within 10 business days of receiving the claim, subject to the provision of all relevant information;
- ii) Where further information is required, request that information within 10 business days of receiving the claim;
- iii) Where a loss adjustor is appointed to investigate the circumstances of the claim, advise the insured accordingly within 5 business days of appointment;
- iv) Keep the insured informed of the progress of the claim, at least every 20 business days; and
- v) Once all relevant information is received, and all investigations are complete, make a determination in respect of the claim within 10 business days.<sup>947</sup>

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<sup>944</sup> *ibid* [257].

<sup>945</sup> *Legal and General Insurance Australia Ltd v Eather* (1986) 6 NSWLR 390, 393-394 (Kirby P). See, *Allan v National Mutual Life Association of Australasia Pty Ltd* (1993) 9 SR (WA) 68; *Giles* (1986) 4 ANZ Insurance Cases 60-751; *Tillotson v ANZ Life Assurance* (1986) 17 SR (WA) 34; James Bremen 'Good Faith and Insurance Contracts – Obligations on Insurers' (1999)19 Aust Bar Rev 89, 92; K C Sutton, 'The Duty of Utmost Good Faith -- Recent Developments' (1994) Australian Business Law Review 22; M Fotheringham, 'Total and Permanent Disability Policies' (1998) 10 ILJ 42.

<sup>946</sup> James Bremen 'Good Faith and Insurance Contracts – Obligations on Insurers' (1999)19 Aust Bar Rev 89, 93.

<sup>947</sup> Insurance Council of Australia, *General Insurance Code of Practice*, (2012) cl 3.2(1)-(5).



#### 6.4.5 Further analysis and recommendation

The proposition of good faith was created by Lord Mansfield. In his view the insured is the main character at the pre-contract stage who, therefore, has the principal duty of disclosure. The insurer is, on the other hand, the main character at the claim stage and as such he should bear the main duty of utmost good faith at this stage.<sup>948</sup> Although the Act failed to determine the nature of this duty, the courts in many cases have endeavoured to characterise the duty. The characteristics that they have identified are sufficient to be a proper guideline of the duty of insurer. However, some of those characteristics are heavily criticised. One of them i.e. the question of ‘good faith’ or ‘utmost good faith’ has been discussed above. The proposition that the insurer’s duty is to hold the insured harmless has been opposed by the Law Commission on the grounds that ‘‘hold harmless’ is a complex and unrealistic way to characterise an insurance contract’.<sup>949</sup> They further said that ‘unlike a security firm, an insurer is in no position to prevent a loss. Buying insurance does not make a fire, flood or theft less likely. Instead, policyholders buy a promise that if something does go wrong, the insurer will provide the payment specified in the contract’.<sup>950</sup> In their view ‘hold harmless’ means that the insurer promises that the loss will not occur. ‘If it does, the insurer is then liable to pay the amount of the claim as damages’.<sup>951</sup> The issue that they have identified is correct if the term is interpreted in the way that the Law Commission did.

However, this view is incorrect if the term is used to mean that the insurer is under a duty to hold the insured harmless once the peril occurs,<sup>952</sup> meaning that the insurer shall pay the insured the loss that he suffered due to the peril. If the insured suffers further losses due to the delay of payment, the insurer is under the duty to pay that additional loss since his duty is to keep the insured safe from the harms derived from the peril. The loss that is caused by the delay in payment constructively derives from the peril. The longer the delay, the higher the burden imposed on the insurer, meaning that insurers will aim to pay claims as soon as possible, even if the claimed amount is doubtful, fearing the consequences of a late payment. Hence, the proposition of ‘holding the insured harmless’ is unreasonable and as such should be replaced by the one proposed by the Law Commission i.e. ‘duty to pay the valid claim’.<sup>953</sup>

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<sup>948</sup> *Ivkovic v Australian Casualty and Life Ltd* (1994) 10 SR (WA) 325; See, James Bremen ‘Good Faith and Insurance Contracts – Obligations on Insurers’ (1999) 19 Aust Bar Rev 89, 92.

<sup>949</sup> *Damages for Late Payment and the Insurer’s Duty of Good Faith* (Issues Paper 6, 2010) para S. 14.

<sup>950</sup> *ibid* para S.14.

<sup>951</sup> *ibid* para S. 11.

<sup>952</sup> Neil Campbell, ‘The nature of an insurer’s obligation’ [2000] LMCLQ 42.

<sup>953</sup> *Damages for Late Payment and the Insurer’s Duty of Good Faith* (Issues Paper 6, 2010) paras 9.48, 9.49.

Australian law considers the duty to be part of the contract, but the Law Commission found no problem of having a statutory duty with some guidelines and damage for foreseeable loss. In author's view the duty may exist either way as long as it serves the purpose. The Law Commission provisionally proposed two categories of duties, the non-excludable duty of *utmost* good faith,<sup>954</sup> and strict liability of paying claims within reasonable time. A duty of the first category is always welcomed in the English law, but the second one may cause controversy. The Law Commission acknowledged that the proposition may lead the insurer 'to react by being less likely to refuse claims which are probably invalid'.<sup>955</sup> They also acknowledged that this reaction from insurers might encourage the insured to submit invalid claims. They, however, did not consider this to be a 'huge risk', because 'it would always be possible for commercial parties to exclude the liability'.<sup>956</sup> As such, they prefer having the risk of illegal gain by the insured.<sup>957</sup> On the other hand, they said that the 'evidence suggests that fraudulent claims are a significant problem'.<sup>958</sup> They, therefore, propose including 'a penal element' in the remedy for making fraudulent claim 'to show society's disapproval of this behaviour and to deter wrongdoing'.<sup>959</sup> Accordingly, it is argued that they are taking contradictory approaches, by deterring fraudulent claims in one hand and leaving the scope for making invalid claim on the other.

However, the positive side of this 'strict liability' is that the insured shall be paid damages for losses that are caused due to the late payment of a valid claim even if the claim is reasonably opposed by the insurer which caused the delay. For example, the insured has made a claim, but the insurer opposes it on a valid ground, meaning that it reaches the courts. The court finds in favour of the insured but, meanwhile, the insured has already suffered huge losses due to the late settlement of his claim. In such a case, the rule of 'utmost good faith' cannot help the insured, but the rule of strict liability can require the insurer to pay the damages for

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<sup>954</sup> The word 'utmost' is not included by the Law Commission, but the author recommends this to be included.

<sup>955</sup> *Damages for Late Payment and the Insurer's Duty of Good Faith* (Issues Paper 6, 2010) para 9.57.

<sup>956</sup> *ibid* para 9.57.

<sup>957</sup> For example, A insured his house against fire risk with B. After the damage caused by fire the insured claimed £50,000 whereas the actual loss was £49,000. A made the claim on 1<sup>st</sup> February. The reasonable time for paying the claim, it is assumed for this example, was 15 working days from receiving claim. Meanwhile the insured stayed at hotel for the cost of £70 per night due to the uninhabitable condition of the house. The insurer found the inconsistency of the amount claimed. The insurer was in dilemma that if he refused the claim but later found that the insured was right then he had to pay more than the alleged excess amount. In such case a normal sensible insurer would prefer giving up his right and pay the excess claim made by the insured.

<sup>958</sup> Law Commission, *Insurance Contract Law: Post Contract Duties and other Issues* (Consultation Paper No 201 and Discussion Paper No 152, 2011) para 6.6.

<sup>959</sup> Law Commission, *The Insured's Post-contract Duty of Good Faith* (Issues Paper 7, July 2007) Para 7.7

this late payment. In this case both parties have got strong arguments. The insured may argue that he has suffered due to the refusal of the claim and as such the insurer has to pay damages for the late payment. The insurer may argue that he has the right to refuse where he doubts the claim and should not be punished for exercising a valid right. In such circumstances the liability can be divided into two parts, the insurer shall pay half of the damages caused by the late payment.<sup>960</sup> Consequently, the above-mentioned danger of paying claims that are probably invalid would be substantially reduced and the insured would also be deterred from taking the chance of submitting invalid claim. However, the Law Commission proposed to impose strict liability subject to express terms of the contract. Needless to say that almost every insurer shall include the express term excluding his liability for his own safeguards and the general market scenario is that the insureds have little negotiation power to change the term, undermining the purpose of the duty. Whereas, this liability is a reasonable one to impose. Accordingly, this strict liability should also be non-excludable, but the duty and remedy have to be imposed in a way that does not cause injustice to any of the parties.

The author, therefore, recommends that *the insurer must handle the claim with utmost good faith considering the reciprocal duty towards the insured and pay the claim within reasonable time. The duty of utmost good faith shall be judged by a reasonable insurer having the subjective knowledge of the circumstances. The duty of utmost good faith shall include, handling claims promptly, considering the interests of the insured before refusing the claim on small or unimportant ground, inquiring into the claim before refusing it, and informing the insured the grounds on which the claim has been refused.*

#### **6.4.6 Duty under Shariah Principles**

The duty of utmost good faith is seemed to be straightforward, but its application is complicated. The courts are uncertain as to how they are going to apply the duty to observe utmost good faith. However, it has been observed that despite the uncertainty within the case law, there are sufficient guidelines for the application of this duty. Under Shariah principles, the duty of utmost good faith is strictly maintained, as mentioned above. Consequently, only the guidelines identified by the courts are required to be considered to find whether they are capable to accommodate Shariah principles. It has already been clarified that the Shariah principles do not provide direct rules on every issue. Accordingly, its basic rules need to be

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<sup>960</sup> The remedy will be discussed further in the next chapter.

followed to resolve such issues, a process which is known as Qiyas. To rely on the rule of Qiyas it is required to find the purpose of the guidelines given by the English courts. If that purpose is supported by the Shariah principles, the guidelines can be maintained under these principles.

The guidelines provided by English courts are, in brief, adequate investigation before refusing a claim,<sup>961</sup> considering the fact related to the claim not the extraneous circumstances,<sup>962</sup> there should not be a delay in payment for an unreasonable cause,<sup>963</sup> the contract should not be avoided for a weak reason,<sup>964</sup> allowing the insured to defend his case before avoiding the contract,<sup>965</sup> the parties should act with a positive and not a negative mind.<sup>966</sup>

If any of these guidelines are not followed, the insured shall be deprived of justice. For example, a failure to adequately investigate shall make the insurer believe the facts incorrectly causing him to refuse the claim, causing injustice whereas justice demands proper knowledge of the facts before taking a decision. Similarly, considering unrelated facts when deciding a claim shall deprive the insured of justice. For example, an insurer found out that the insured lied to his friend on a certain occasion. Relying on this issue, the insurer refuses the claim on the grounds that the insured has a record of lying and as such he might be lying when disclosing facts related to the claim. Justice, on other hand, demands that each case needs to be considered on its own merit. Other facts might be persuasive but not decisive. Accordingly, the insured is deprived of justice in this example. An unreasonable delay in the payment of the claim also causes injustice in the view of Shariah principles. Prophet Muhammad (PBUH) said,

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<sup>961</sup> *Drake Insurance Plc v Provident Insurance Plc* [2003] EWCA Civ 1834; [2004] QB 601, [177] (Pill LJ).

<sup>962</sup> *Gan Insurance Co Ltd v Tai Ping Insurance Co Ltd* [2001] EWCA Civ 1047; [2001] CLC 1103 [76].

<sup>963</sup> *ibid* [68].

<sup>964</sup> *Drake Insurance Plc v Provident Insurance Plc* [2003] EWCA Civ 1834; [2004] QB 601, [91] (Rix LJ); [144] (Clarke LJ); *Pan Atlantic Insurance v Pine Top Insurance*, [1994] 3 All E.R. 581, 623; see also A Naidoo & D Oughton, 'The confused post-formation duty of good faith in insurance law: from refinement to fragmentation to elimination?' (2005) JBL 346, 363.

<sup>965</sup> *ibid* [92] (Rix LJ).

<sup>966</sup> *Banque Financiere de la Cite v Westgate Insurance Co Ltd*, [1987]2 WLR 1300, 1328. Although the remedy of this court was overruled by the Court of Appeal, the duty explained by this court was reiterated by the later court. See, for instance [1990] 1 QB 665, 770-771. The decision in *Drake Insurance Plc v Provident Insurance Plc* [2003] EWCA Civ 1834 carries the similar approach. William, J. Perry and Heidi Nash-Smith 'Drake v Provident's Effect on Insurers' Duty of Good Faith in English Law', (July 2005)72 (3) Defense Counsel Journal 298, 302

حَدَّثَنَا يَحْيَى عَنْ مَالِكٍ عَنْ أَبِي الزِّنَادِ عَنِ الْأَعْرَجِ عَنْ أَبِي هُرَيْرَةَ أَنَّ رَسُولَ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ قَالَ مَطْلُ الْغَنِيِّ ظُلْمٌ وَإِذَا أُتْبِعَ أَحَدُكُمْ عَلَى مَلِيسٍ فَلْيُتْبِعْ

*Yahya related to me from Malik from Abu'z-Zinad from al Araj from Abu Hurayra that the Messenger of Allah, may Allah bless him and grant him peace, said, 'Delay in payment by a rich man is injustice, but when one of you is referred for payment to a wealthy man, let him be referred.'*<sup>967</sup>

The end result of all the above-mentioned guidelines, except the two discussed above, is prevention of injustice. Islamic law emphasises maintaining justice at every level of a transaction. As Allah (SWT) says,

يَا أَيُّهَا الَّذِينَ ءَامَنُوا لَا تَأْكُلُوا أَمْوَالِكُمْ بَيْنَكُمْ بِالْبَاطِلِ إِلَّا أَنْ تَكُونَ تِجَارَةً عَنْ تَرَاضٍ مِنْكُمْ. وَلَا تَقْتُلُوا أَنْفُسَكُمْ إِنَّ اللَّهَ كَانَ بِكُمْ رَحِيمًا. .  
ومن يفعل ذلك عدوانا وظلما فسوف نصليه نارا وكان ذلك على الله يسيرا

*O you who believe, Eat not up your property among yourselves unjustly except it be a trade amongst you, by mutual consent. And do not kill yourselves (nor kill one another). Surely, Allah is Most Merciful to you. And whoever commits that through aggression and injustice, We shall cast him into the Fire, and that is easy for Allah.*<sup>968</sup>

It is further said in the Quran

إن الله يأمر بالعدل والاحسان

*Verily, Allah orders justice and kindness.*<sup>969</sup>

Imam Muslim said that 'the Holy Prophet (May peace be upon him) based business dealings strictly on truth and justice. He has strongly disapproved of all transactions which involve any kind of injustice or hardship to the buyer or the seller'.<sup>970</sup> Prophet Muhammad (PBUH) said:

عَنْ أَبِي هُرَيْرَةَ قَالَ قَالَ رَسُولُ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ لَا تَحَاسِدُوا وَلَا تَنَاجَشُوا وَلَا تَبَاغَضُوا وَلَا تَدَابِرُوا وَلَا يَبِعْ بَعْضُكُمْ عَلَى بَعْضٍ وَكُونُوا عِبَادَ اللَّهِ إِخْوَانًا الْمُسْلِمُ أَخُو الْمُسْلِمِ لَا يَظْلِمُهُ وَلَا يَخْدُلُهُ وَلَا يَحْقِرُهُ التَّقْوَى

<sup>967</sup> Imam Malik bin Anas, *Al-Muatta*, Kital al-Buyu, وَالْحَوْلِ وَالَّذِينَ No. 1379. (Trs.) Book 31, Number 31.39.85

<sup>968</sup> *The Holy Quran*, 4: 29-30.

<sup>969</sup> *ibid* 16: 90.

<sup>970</sup> Abdul Hamid Siddiqi (tr), *Sahih Muslim* (SH. Muhammad Ashraf, Kashmiri Bazar, Lahore, Pakistan 1973) 792.

هَاهُنَا وَيُشِيرُ إِلَى صَدْرِهِ ثَلَاثَ مَرَّاتٍ بِحَسَبِ أَمْرِي مِنَ الشَّرِّ أَنْ يَحْتَوِرَ أَخَاهُ الْمُسْلِمَ كُلُّ الْمُسْلِمِ عَلَى الْمُسْلِمِ  
حَرَامٌ دَمُهُ وَمَالُهُ وَعِرْضُهُ

*Abu Huraira reported Allah's Messenger (may peace be upon him) as saying: Don't nurse grudges and don't bid him out for raising the price and don't nurse aversion or enmity and don't enter into a transaction when the others have entered into that transaction and be as fellow-brothers and servants of Allah. A Muslim is the brother of a Muslim. He neither oppresses him nor humiliates him nor looks down upon him. The piety is here, (and while saying so) he pointed towards his chest thrice. It is a serious evil for a Muslim that he should look down upon his brother Muslim. All things of a Muslim are inviolable for his brother in faith: his blood, his wealth and his honour.<sup>971</sup>*

According to the above-mentioned texts, it is evident that Shariah principles support all the rules that prevent injustice. Since the guidelines made by the courts are meant to establish justice in insurance contracts and all of them, except two, effectively prevent injustice, the Shariah principles should allow those guidelines to be applied in Islamic policies. However, two of those guidelines are submitted to be incapable of establishing justice for the reasons discussed above, these are, in liability and property insurance the insurer must hold the insured harmless against the liability or loss insured against,<sup>972</sup> and secondly, the insurer's duty is to observe 'good faith' not 'utmost good faith'.<sup>973</sup> The author has rejected their application in English insurance law and recommended a duty applying the rest of the guidelines. It is submitted that the author's recommended duty should establish fairness between the parties and as such should be Shariah compliant. If the English law applies that duty, the Islamic insurers shall have a supportive environment for the application of Islamic policies. However, until the recommended duty is applied in English law, Islamic insurers should incorporate adequate terms to give effect to the recommended duty.

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<sup>971</sup> A A Muslim *Sahih Muslim*, كتاب البر والصلة والآداب، No. 2564; A. A. Muslim, *Sahih Muslim*, (USC Centre for Muslim-Jewish Engagement tr, <<http://www.usc.edu/org/cmje/religious-texts/hadith/muslim/032-smt.php>>) Book 032, Number 6219. Accessed 05/07/2013.

<sup>972</sup> See, *The Fanti and The Padre Island* [1991] 2 AC 1, 35 (Lord Goff); *Insurance Corporation of the Channel Islands Ltd and Another v McHugh and Royal Hotel Limited* [1997] LRLR 94 (Mance J).

<sup>973</sup> *The Standard Steamship Owners' Protection and Indemnity Association (Bermuda) Ltd v Oceanfast Shipping Ltd (The Ainikolas I)* (QBD (Comm Ct) Lexis Transcript, 7 March 1996) (Mance J).

## **6.5 Conclusion**

The courts and academics are of the opinion that the duty of utmost good faith continues throughout the policy. There are three stages of a policy, before making the contract, during the policy and at the time of claim. The duty of the second stage has been overlooked by courts and academics, and are of the opinion that the insured has nothing to disclose after the contract is entered into. They believe that once the parties are in the contract, they are bound by it and further disclosure shall not make any difference to their liability. Instead, the author considers it as a continuing contract where the duty of utmost good faith of each party continues. For example, a tenant and his landlord have a continuing contract where no one can make any changes to the property that may concern the other unless he obtains permission or it is something that a reasonable person in his position would do so. Similarly the insured should have the duty not to do something with the insured object that may concern the insurer unless he obtains his permission or it is something that a reasonable person in his position would have done had there been no policy. However, if the change is caused by nature, which is out of the insured's control, then he is not required to ask for consent or communicate the changed circumstances to the insurer.

The common law duty of not to make fraudulent claims has been imposed on the insured at the claim stage. The duty under section 17 is applied only in exceptional cases of fraudulent claims. Whereas 'utmost good faith' demands the further duty of disclosing facts that should help the insurer adequately decide the accuracy of the claim and also co-operating with the investigator. Mance LJ divided the claim stage into two parts, the device, which is used to make the claim, and the claim itself. In both cases he imposed the common law duty of not to make fraudulent claim. He provided a narrow or incomplete explanation of 'device', which fails to cover different kinds of breaches. The author, therefore, recommends a wider definition of 'device' and recommends a specific duty related to device and claim.

The courts are confused whether to impose a statutory or contractual duty on the insurer at the claim stage. If the current statutory duty is applied, the remedy for that breach rewards the insurer instead whilst an implied term duty cannot be applied since it fails to satisfy the prerequisites for an implied term. Mance LJ and the Law Commission take the view that the duty is to act with 'good faith' not 'utmost good faith'. The Law Commission proposed in their issues paper to impose two categories of duty, a non-excludable duty of 'good faith' and the strict liability to pay valid claim in a reasonable time. The insurers will be liable to pay

foreseeable damages for late payment even if the delay is caused due to their reasonable suspicion in the claim. This causes injustice to the insurer. However, the insurer shall be allowed to exclude such liability by an express term of the contract. It is obvious that in almost every case the insurer shall exclude this liability making the duty superfluous. The mere duty of 'good faith' shall not be sufficient to require the insurer to handle the claim considering the interest of the insured. The author, therefore, recommends applying the duty of 'utmost good faith' in handling the claim and also suggests applying the guidelines that are identified by the courts.

The Shariah principles are flexible in the application of the duty as long as the duty does not cause injustice or oppression to any of the parties. There is apparently no duty on the insured at the second stage of the contract under current English insurance law. This causes injustice and in some cases causes oppression to the other party. Consequently, current English insurance law is not Shariah compliant. This part of the current law can be Shariah compliant if the author's recommended duty is applied. However, until the recommended duty is adopted, the Islamic insurers should write adequate terms giving effect to the recommended duty so as to make the policies Shariah compliant. They should also write adequate terms giving effect to the recommended duty for the insured and insurer at the claim stage since the current English law imposes unjustifiable duty leading it to be unacceptable by Shariah principles. However, if the recommended duty for the claim stage is applied in English law, this part of the English law shall accommodate Shariah principles.

## **Appendix**

The Law Commission in their Consultation Paper No 201, published in December 2011, considered the reform of the third stage of the contract. They proposed that the insurer 'should be under a contractual obligation to pay valid claims within a reasonable time'.<sup>974</sup> The reasonable time should be calculated considering the time for investigation (including time to seek information from third parties where necessary) and reviewing the claim 'taking into account market practice, the type of insurance, and the size, location and complexity of the claim'.<sup>975</sup> It was also suggested that the time calculation for investigation should only

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<sup>974</sup> The Law Commission and the Scottish Law Commission, *Insurance Contract Law: Post Contract Duties and Other Issues* (Consultation Paper No 201, Discussion Paper No 152, 2011) para 5.9.

<sup>975</sup> *ibid* paras 5.12, 5.14.



begin once the insured provides all the material information requested by the insurer in reasonable manner.<sup>976</sup>

Considering the different guidelines, (such as Insurance Conduct of Business Sourcebook, Association of British Insurers' Codes of Practice and Guidance Notes), that insurers have to follow the Law Commission proposed not to include any further guidance in legislation on good faith in claims handling so as to avoid unnecessary complexity and confusion.<sup>977</sup> The Law Commission did not propose any specific duty of the insured during the claim procedure but made proposals on remedies for fraudulent claims. This is discussed in the appendix of Chapter 7.

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<sup>976</sup> *ibid* para 5.14.

<sup>977</sup> *ibid* paras 5.35-37.

## Chapter 7 – Remedy for Breach of Continuing Duty of Utmost Good Faith

### 7.0 Introduction

The statutory remedy, i.e. avoidance *ab initio*, as stated in Chapter 5 is also applicable for breach of post-contract duty of observing utmost good faith. It makes no difference to the availability of the remedy whether the breach is due to an innocent mistake, negligence or fraud. The courts however are against the application of this remedy for any kind of breach apart from fraudulent breaches. The courts are also reluctant to apply this remedy for fraudulent breaches unless that fraud is material with an effect on the underwriters' ultimate liability and the gravity of fraud is such as would enable the underwriters if they wished to do so to terminate for breach of contract.<sup>978</sup> It is apparent from the approach of the courts that the current statutory remedy is too harsh and not suitable for post-contract breaches.

The courts therefore endeavoured to find an escape by categorising the duty. Some categorised it as an implied duty<sup>979</sup>, whilst some categorised it as the duty of 'good faith' rather than 'utmost good faith'.<sup>980</sup> In *The Star Sea*,<sup>981</sup> the court held that the duty of utmost good faith varies according to the circumstances of the contract. Where the duty varies according to the circumstances, logic suggests that the remedy should also vary according to that variation of the duty.<sup>982</sup> Hence, the absence of varied nature of remedy under section 17 places the court in a dilemma as to how those remedies should be applied. The Law Commission in their issues paper suggested to specify the appropriate remedy for each specific breach and opposed the application of the duty of utmost good faith through an implied term. The loophole of implied duty is that it does not make a party liable unless the other suffers any damage due to the breach leading a party free to breach the duty until it causes damage to the other party. Whereas the purpose of the law includes prevention of the breach. In such case a specific remedy against specific categories of breach should be the best possible solution. The application of a specific remedy for a specific breach should establish fairness between the interests of the insured and insurer. Such fair remedies should make this part of English insurance law Shariah compliant except in cases where the contradiction

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<sup>978</sup> *The Mercandian Continent* [2001] EWCA Civ 1275; [2001] 2 Lloyd's Rep. 563 [35] (Longmore LJ).

<sup>979</sup> *Black King Shipping Corporation and Wayang (Panama) S.A. v Mark Ranald Massie (The 'Litsion Pride')* [1985] 1 Lloyd's Rep. 437, 518-9 (Hirst J).

<sup>980</sup> *The Standard Steamship Owners' Protection and Indemnity Association (Bermuda) Ltd v Oceanfast Shipping Ltd (The Ainikolas I)* (QBD (Comm Ct) Lexis Transcript, 7 March 1996) (Mance J).

<sup>981</sup> *Manifest Shipping Co Ltd v Uni Polaris Shipping Co Ltd (The Star Sea)* [2001] UKHL 1, [2001] 2 WLR 170.

<sup>982</sup> Malcolm A. Clarke, *The Law of Insurance Contracts* (6th edn, Informa 2009) para 27 1A2.

derives from the operational differences. In those cases the Islamic insurers shall have no choice except incorporating special terms so as to make the policies Shariah compliant.

It has been explained in Chapter Six that two categories of duties are imposed once the policy commences. The first one relates to the second stage of the contract and the second one relates to the third stage of the contract. Consequently, the analysis of the remedy should also be discussed in two parts.

### **7.1 Breach of Duty at the Second Stage of the Contract – During the Policy**

It has been discussed in Chapter Six that there is no requirement of imposing any specific duty on an insurer during the policy since the regulatory body monitors their affairs so as to ensure that they provide adequate service to their customers. In the absence of such specific duty there is no room for suggesting remedy for the insured against the insurer. Hence, the discussion of this part of the remedy will be based on the breach of the duty by the insured only.

#### **7.1.1 The Current English Insurance Law**

The perfect example of a breach of utmost good faith at the second stage of the policy is *The Litsion Pride*.<sup>983</sup> The terms of the policy in this case stated inter alia that,

1 (A) This coverage shall extend worldwide, but in the event of a vessel...insured hereunder sailing for...or being within the Territorial Waters of any of the Countries or places described in the Current Exclusions...additional premium shall be paid at the discretion of Insurers...(B) Information of such voyage...shall be given to Insurers as soon as practicable and the absence of prior advice shall not affect the cover...'

The owners of the vessel wished to avoid paying a substantial additional premium and intended to slip in and out of the dangerous waters without notifying their insurers, in a clear breach of utmost good faith and the terms of the contract during the second stage of the policy.<sup>984</sup> Hirst J interpreted section 17 stating that under this section 'the policy may be avoided, not that it must be avoided.' He held that in the pre-contract breach 'the assured's default necessarily strikes at the very basis of the contract itself,' but in the case of a post-

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<sup>983</sup> *Black King Shipping Corporation and Wayang (Panama) S.A. v Mark Ranald Massie (The 'Litsion Pride')* [1985] 1 Lloyd's Rep. 437

<sup>984</sup> *ibid* 512 (Hirst Justice).

contract breach ‘the same considerations do not apply’.<sup>985</sup> Accordingly, ‘in the case of post-contract breach it is open to the underwriter simply to defend the claim without avoiding the policy’.<sup>986</sup>

Opposing this view academics like Eggers, Picken and Foss commented that the remedy under section 17 ‘is an all or nothing remedy’.<sup>987</sup> If the insurer does not avoid the contract he has to pay the valid claim,<sup>988</sup> and there is no scope to take half of it since the purpose of the remedy is ‘to undo the contract’.<sup>989</sup> A similar view was held by the courts in subsequent cases such as *Orakpo v Barclays Insurance Services*<sup>990</sup> and *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd (The Star Sea)*.<sup>991</sup> Lord Hobhouse said in the latter case that the ‘right to avoid referred to in s 17 is different. It applies retrospectively. It enables the aggrieved party to rescind the contract *ab initio*’.<sup>992</sup> Accordingly, the interpretation of section 17 in *The Litsion Pride*<sup>993</sup> is no longer effective.

However, the remedy has been narrowly applied by the courts due to its drastic consequences.<sup>994</sup> In *K/S Merc-Scandia XXXXII v Certain Lloyd’s Underwriters (The Mercandian Continent)*<sup>995</sup> the court imposed several conditions for the remedy to be applied. The first of them is that the breach has to be fraudulent. The second is that the said fraud must be material having an effect on the underwriter’s ultimate liability and the third is that the fraud must be so serious as to ‘justify the insurer in accepting the insured’s conduct as a repudiation of the contract’.<sup>996</sup>

Since the statutory remedy is saved for special fraud cases, the courts rely on common law remedy for fraudulent breaches that do not satisfy above conditions. The common law

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<sup>985</sup> *ibid* 515 (Hirst Justice).

<sup>986</sup> *ibid* 515 (Hirst Justice).

<sup>987</sup> Peter Macdonald Eggers, Simon Picken and Partrick Foss *Good Faith and Insurance Contracts* (2nd edn, LLP 2004) 443.

<sup>988</sup> *ibid* 444.

<sup>989</sup> *ibid* 445.

<sup>990</sup> [1995] LRLR 443; *Galloway v Guardian Royal Exchange (UK) Ltd* [1999] Lloyd’s Rep IR 209.

<sup>991</sup> [2003] 1 AC 469, [2001] 1 All ER 743.

<sup>992</sup> *ibid* [51].

<sup>993</sup> *Black King Shipping Corporation and Wayang (Panama) S.A. v Mark Ranald Massie (The ‘Litsion Pride’)* [1985] 1 Lloyd’s Rep. 437

<sup>994</sup> Peter Macdonald Eggers, Simon Picken and Partrick Foss *Good Faith and Insurance Contracts* (2nd edn, LLP 2004) 445.

<sup>995</sup> [2001] EWCA Civ 1275, [2001] Lloyd’s Rep. I.R 802 [35] (Longmore LJ).

<sup>996</sup> *ibid* [26] (Longmore LJ)

remedy is to avoid the whole claim without avoiding the contract.<sup>997</sup> The Scottish court, on the other hand, in *Fargnoli v GA Bonus Plc*<sup>998</sup> held considering the relationship of mutual good faith between two parties that a claim tainted by fraud should not have ‘any validity whatsoever’ but shall not affect an earlier claim.<sup>999</sup>

Academics like John Birds invite the parties to rely on contractual remedies along with the common law remedy considering the approach of the courts.<sup>1000</sup> Professor Malcolm A. Clarke suggests that the duty, other than in fraudulent cases, derives from an implied term of the contract, breach of which shall put the insurer in the position they would have been had the breach not occurred. For example, if the insured fails to notify the insurer and as such does not obtain consent about an alteration of risk ‘the insurer should be entitled to charge (retrospectively) a premium that reflects the alteration of risk’.<sup>1001</sup> Lord Hobhouse in *Manifest Shipping Co Ltd v Uni Polaris Shipping Co Ltd (The Star Sea)*, held the similar view that the remedy for breach of the continuing duty should derive from the contract and attract only those remedies provided by the law of contract.<sup>1002</sup> Referring to this judgement Halsbury’s Laws of England stated that for breach of continuing duty of utmost good faith ‘an injured party will not be able to avoid the contract as a whole but must rely on his contractual remedies’.<sup>1003</sup> Professor Malcolm A. Clarke, However, suggested that the remedy of rule of law should be applied in the case of fraudulent breach.<sup>1004</sup> His subsequent comments made clear that he meant ‘the common law’ by the term ‘rule of law’.<sup>1005</sup>

In summary there are four categories of remedies suggested to be applied for breach of continuing duty of utmost good faith, a remedy under express term of the contract, remedy under implied term of the contract, statutory remedy and a common law remedy.

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<sup>997</sup> *ibid* [35] (Longmore LJ); *Agapitos v Agnew; The Aegeon* [2002] EWCA Civ 247; [2002] 3 WLR 616 [43] (Mance LJ); *Axa General Insurance Ltd v Gottlieb* [2005] EWCA Civ 112; [2005] 1 All ER (Comm) 445 [31].

<sup>998</sup> 1997 SCLR 12; [1997] CLC 653.

<sup>999</sup> *ibid* 670 (Lord Penrose).

<sup>1000</sup> John Birds, *Birds’ Modern Insurance Law* (8<sup>th</sup> edn, Sweet & Maxwell 2010) 143.

<sup>1001</sup> Malcolm A. Clarke, *The Law of Insurance Contracts* (6<sup>th</sup> edn, Informa 2009) para 27 1A2.

<sup>1002</sup> [2001] UKHL 1, [2001] 2 WLR 170, [52]. *Orakpo v Barclays Insurance Services* [1995] LRLR 443, 383 (Lord Justice Hoffmann). *K/S Merc-Scandia XXXXII v Certain Lloyd’s Underwriters* [2001] EWCA Civ 1275, [2001] 2 Lloyd’s Rep 563 [35], (Longmore LJ); *Goshawk Dedicated Ltd v Tyser & Co Ltd* [2006] EWCA Civ 54, [2006] 1 All ER (Comm) 501.

<sup>1003</sup> Halsbury’s Law of England (2003 Reissue) Vol 25, para 45, 392.

<sup>1004</sup> Malcolm A. Clarke, *The Law of Insurance Contracts* ((6<sup>th</sup> edn, Informa 2009), para 27-1A2.

<sup>1005</sup> *ibid* para 27-2C3.

The remedy included by the express terms of the contract is subject to The Unfair Terms in Consumer Contracts Regulations 1999. Article 5 (1) states that a ‘contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties’ rights and obligations arising under the contract, to the detriment of the consumer’. The regulations require terms to be drafted in ‘plain’, ‘intelligible language’.<sup>1006</sup> They also require the terms to be fair. A term that is unexpectedly harsh may well be considered unfair if it is not brought to the policyholder’s attention. Where the term is unfair the contract shall bind the parties without that alleged term.<sup>1007</sup> However, Article 6 (2) of the Regulation states that ‘In so far as it is in plain intelligible language, the assessment of fairness of a term shall not relate...to the definition of the main subject matter of the contract’. In *Bankers Insurance Co v South*,<sup>1008</sup> a holiday-maker had taken out a travel insurance policy in 1997 which exempted ‘compensation or other costs arising from accidents involving...possession of any...motorised waterborne craft’. Whilst riding a jet ski he had been involved in an accident which seriously injured another jet skier. It was accepted by the parties that the term defined the main subject matter of the contract within the meaning of the Regulation. The insured, however, argued that the term was not in ‘plain, intelligible language’ under Article 3 (2) of the Regulation 1994,<sup>1009</sup> which was similar to that of Article 6 (2) of the Regulation 1999. Buckley J rejected their argument and held that the term was in ‘plain and intelligible language’.<sup>1010</sup> A consumer can also approach FOS who decides the cases on fairness.<sup>1011</sup> Accordingly, the remedy for breach of the post-contract duty is further dependent on three parts of the Law, statute (section 17 of the Marine Insurance Act 1906, the Unfair Terms in Consumer Contracts Regulations 1999 and the FOS).

The law is not yet clear whether the insurer shall be allowed damages for investigating the fraud of the insured during the policy. According to the decision in *London Assurance v Clare*<sup>1012</sup> the insurer is not allowed to damages. However, it is open to an insurer to argue that they are entitled to claim damages for the intention of the insured to deceit the insurer. In

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<sup>1006</sup> Article 7(1) of The Unfair Terms in Consumer Contracts Regulations 1999.

<sup>1007</sup> Article 8 of The Unfair Terms in Consumer Contracts Regulations 1999.

<sup>1008</sup> [2003] EWHC 380 (Comm), [2004] Lloyd’s Rep IR 2.

<sup>1009</sup> The Unfair Terms in Consumer Contracts Regulations 1994 was repealed by The Unfair Terms in Consumer Contracts Regulations 1999 on October 1, 1999.

<sup>1010</sup> [2003] EWHC 380 (Comm), [2004] Lloyd’s Rep IR 2 [24].

<sup>1011</sup> See, Section 228(2) of Financial Services and Markets Act 2000.

<sup>1012</sup> (1937) 57 Ll. L. Rep. 254, 270 (Goddard J).

*Insurance Corporation of the Channel Islands Ltd v McHugh*,<sup>1013</sup> the allegations of deceit were pleaded by the insurers but not really pursued at trial. Mance J dismissed the claim on the basis that it had not been argued but acknowledged that it could be arguable in principle.

### 7.1.2 Critical Analysis of the Current English Insurance Law

It becomes clear from the approach of the courts and the academics that the statutory remedy is unreasonably harsh and no court is interested to apply and everyone is confused as to what remedy should establish the expected fairness between the parties to the contract.<sup>1014</sup> The said confusion made the courts and academics suggest different categories of remedies leading uncertainty in the remedy. The uncertainty in the remedy causes unfairness in the judgement such as when the insured commits a wrong he may think that his act is not punishable. If he is finally punished then it shall be unfair for him. The uncertainty has further been enhanced by the interpretation of the terms of the contract by the court in *Kausar v. Eagle Star Insurance Co*,<sup>1015</sup> which has been discussed above. In this case, the term of the contract required that the insured ‘*must tell [the insurer] of any change of circumstances after the start of the insurance which increases the risk of injury or damage. [He] will not be insured under the policy until [both parties] have agreed in writing to accept the increased risk*’.<sup>1016</sup> The insurer argued that the failure of communication regarding the change of circumstances by the insured have made the insurer entitled to exclude the claims of damages, arising from the operation of perils to which the change of circumstances related, by virtue of the said term of the contract. The court on the other hand interpreted the term holding that it represents the common law rule where the change of circumstances is so serious that a new agreement is required for the cover. A similar fate has been received by the insurer in *Shaw v Robberds*,<sup>1017</sup> despite the presence of an increase of risk clause. In this case, the court reasoned its judgment holding that the change of circumstances was temporary and as such was not covered by the clause. If the insurer wished to be notified of merely temporary increases in risk, it must insert express clauses to that effect.<sup>1018</sup> Consequently, the inclusion of a term in a contract cannot guarantee the insurer to have the intended remedy. In *Ansari v New India Assurance Ltd*,<sup>1019</sup> the court

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<sup>1013</sup> [1997] 1 LRLR 94, 135.

<sup>1014</sup> See, Law Commission and Scottish Law Commission, *The Insured’s Post-Contract Duty of Good Faith* (Issues Paper 7, July 2010) para 4.18.

<sup>1015</sup> *Kausar v. Eagle Star Insurance Co* [2000] Lloyd’s Rep IR 154

<sup>1016</sup> (emphasis added).

<sup>1017</sup> (1837) 6 A. & E. 75.

<sup>1018</sup> See, e.g. *Glen v Lewis* (1853) 8 Ex. 607.

<sup>1019</sup> [2009] EWCA Civ 93, [2009] Lloyd’s Rep. I.R. 562.

however interpreted the term as it was intended by the insurer since the term included the words ‘material change’ and the court found the change in circumstances was material and continuous. The scenario might have been different if the insurer had included the words ‘any change of circumstances’, the term that was used in *Kausar v. Eagle Star Insurance Co*,<sup>1020</sup> instead of ‘material change’. The position has further been complicated, following *The Star Sea*,<sup>1021</sup> doubting whether a duty of good faith affects such terms. Even if it does, it is unlikely that the courts would allow the insurer to avoid the contract if the term is breached. As Longmore LJ stated in *The Mercandian Continent*<sup>1022</sup> ‘it is not usually suggested that breach of any such term gives rise to a right to avoid the contract rather than a claim to damages’. Whereas, the Court of Appeal in the latter case of *Ansari*<sup>1023</sup> allowed the insurer to avoid the policy following the term of the contract. They viewed the turning off the sprinkler system as an alteration of the risk instead of an increase of risk.<sup>1024</sup> Distinguishing the case *Kausar v. Eagle Star Insurance Co*,<sup>1025</sup> Moore-Bick LJ held that the case shall be governed not by the common law but by the term of the contract and as such allowed the insurer to avoid the policy.<sup>1026</sup> Such a contradictory approach of the courts makes the parties heavily confused about the right step that they should take.

Though the decision in *Ansari*<sup>1027</sup> has made the situation blurred, the majority of courts including the House of Lords are reluctant to allow the avoidance *ab initio* due to its unfair effect on the insured. The question of fairness, on the other hand, is the principal guideline for the FOS who are not bound to follow the courts’ decisions. Consequently, the parties to an insurance contract are not clear how they should incorporate the terms and in what circumstances the terms would or would not be upheld in court. Further, there are no specific guidelines for the insurer to judge what term is going to be unfair. Consequently, an insurer is always in risk of losing the entire benefit of a term. Whereas, a well-founded guideline could help the insurer to write the term accurately as he can get expected return without losing

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<sup>1020</sup> *Kausar v. Eagle Star Insurance Co* [2000] Lloyd’s Rep IR 154

<sup>1021</sup> *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd (The Star Sea)* [2001] UKHL 1; [2003] 1 AC 469.

<sup>1022</sup> *K/S Merc-Scandia XXXXII v Certain Lloyd’s Underwriters (The Mercandian Continent)* [2001] EWCA Civ 1275; [2001] 2 Lloyd’s Rep 563, 571.

<sup>1023</sup> [2009] EWCA Civ 93, [2009] Lloyd’s Rep. I.R. 562.

<sup>1024</sup> *ibid* [46] (Lord Justice Moore-Bick).

<sup>1025</sup> *Kausar v. Eagle Star Insurance Co* [2000] Lloyd’s Rep IR 154

<sup>1026</sup> [2009] EWCA Civ 93, [2009] Lloyd’s Rep. I.R. 562 [45] (Moore-Bick LJ).

<sup>1027</sup> *ibid*.



everything. In summary it is submitted that, the English law in this area, is confusing, uncertain and unfair, leading to injustice to the parties.<sup>1028</sup>

The current law is also inadequate, as it fails to determine a reasonable remedy when the fraud takes place during the policy but is discovered a considerable time after when the valid claim is made. According to the current approach of the courts such fraud shall not automatically invalidate the contract but entitle the insurer to rescind it.<sup>1029</sup> Since the available remedy has not been demanded before the valid claim is made due to the lack of knowledge of the fraud, the insurer shall be deprived from the remedy of that fraud and be bound to pay the valid claim meaning that the insured escapes the punishment for his malpractice.

The situation becomes even worse for the insurer where the insured either honestly or negligently temporarily changes the risk, as in *Shaw v Robberds*,<sup>1030</sup> which causes the peril. In such case the insurer has to pay the full claim without having any remedy against the palpable error of the insured.

### 7.1.3 The Approach of the Law Commission

In the view of Law Commission the current law is complex and vague which needs to be clear. They provisionally proposed that for ‘each specific breach, the legislation should specify an appropriate remedy’.<sup>1031</sup> Supporting the current view of the court they suggested that the current statutory remedy of ‘avoidance’ should be available for appropriate cases.<sup>1032</sup>

The current restrictive approach of interpreting contractual terms is also favoured by the Law Commission.<sup>1033</sup> They are of the opinion that the insurer should be entitled to claim damages for investigating fraud.<sup>1034</sup>

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<sup>1028</sup> See, Law Commission and Scottish Law Commission, *The Insured’s Post-Contract Duty of Good Faith* (Issues Paper 7, July 2010) para s.8.

<sup>1029</sup> *The Star Sea Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd and Others (The Star Sea)* [2001] UKHL 1; [2003] 1 A.C. 469 [110] (Lord Scott); *Axa General Insurance Ltd v Gottlieb* [2005] EWCA Civ 112; [2005] 1 All ER (Comm) 445 [22] (Mance LJ), [1997] CLC 653, 662 (Lord Penrose); *Fargnoli v G A Bonus pls* [1997] CLC 653, 662 (Lord Penrose).

<sup>1030</sup> (1837) 6 A. & E. 75.

<sup>1031</sup> Law Commission and Scottish Law Commission, *The Insured’s Post-Contract Duty of Good Faith* (Issues Paper 7, July 2010) para 7.11 (4).

<sup>1032</sup> *ibid* para 7.11 (4).

<sup>1033</sup> *ibid* paras 6.45, 6.46.

<sup>1034</sup> *ibid* para 7.41.

#### 7.1.4 The Legal Position in Australia

As a common law country, Australia used to apply the common law remedy of avoidance. As this remedy was too harsh for the insureds, the argument was raised to consider the duty to observe utmost good faith as an implied term of the insurance contract or the duty should give rise to a duty of care subject to the law of tort. In both scenarios, it was argued that the appropriate remedy was not rescission, but damages.<sup>1035</sup> The tortious duty was rejected by the courts in *Lomsargis v National Mutual Life Association of Australasia Ltd*<sup>1036</sup> and *CGU Workers Compensation (NSW) Ltd v Garcia*,<sup>1037</sup> primarily on the basis that it would ‘cut across the legislative and contractual framework, in some respects shattering the coherence of the scheme’.<sup>1038</sup> The Australian Parliament followed the recommendation of their Law Reform Commission and incorporated section 13 making the duty an implied term of the insurance contract, breach of which gives rise to an entitlement to damages, assessed in accordance with ordinary contractual principles. This is a flexible remedy based on the seriousness of the breach.

#### 7.1.5 Further Analysis and Recommendation

As the current position of the remedy is uncertain in English law, the Australian example of the implied term could be followed and has been effectively followed in some English cases<sup>1039</sup>, but was rejected by later cases.<sup>1040</sup> Academics like Naidoo & Oughton,<sup>1041</sup> and Clarke<sup>1042</sup> are in favour of the implied term theory since ‘the difficulties can be resolved using the implied term theory’.<sup>1043</sup> The other side of the coin represents the negative impact of implied term theory. The insurer may claim specific figure showing that they would have increased the premium by that amount, which might be contradictory, placing the court in a dilemma as to whether to allow general damage or specific damage causing unnecessary delay in the case. Further, such contractual remedies may undermine the basis of insurance

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<sup>1035</sup> See, Matthew Ellis, ‘Utmost good faith: The scope and application of s 13 of the Insurance Contracts Act in the wake of *CGU v AMP*’ (2009) 20 Insurance Law Journal 97.

<sup>1036</sup> [2005] 2 Qd R 295; (2005) 192 FLR 400; (2006) 14 ANZ Ins Cas 61-671; BC200505069.

<sup>1037</sup> (2007) 69 NSWLR 680; 14 ANZ Ins Cas 61-746; [2007] NSWCA 193; BC200706429.

<sup>1038</sup> *CGU Workers Compensation (NSW) Ltd v Garcia* (2007) 69 NSWLR 680; 14 ANZ Ins Cas 61-746; [2007] NSWCA 193; BC200706429, at NSWLR 692.

<sup>1039</sup> *Black King Shipping Corporation and Wayang (Panama) S.A. v Mark Ranald Massie (The ‘Litsion Pride’)* [1985] 1 Lloyd’s Rep. 437

<sup>1040</sup> *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd (The Star Sea)* [2001] UKHL 1; [2003] 1 AC 469.

<sup>1041</sup> Andre Naidoo & David Oughton ‘The confused post-formation duty of good faith in insurance law: from refinement to fragmentation to elimination?’ (2005) JBL 346, 352.

<sup>1042</sup> Malcolm A. Clarke, *The Law of Insurance Contracts* ((6<sup>th</sup> edn, Informa 2009), para 27 1A2.

<sup>1043</sup> Andre Naidoo & David Oughton ‘The confused post-formation duty of good faith in insurance law: from refinement to fragmentation to elimination?’ (2005) JBL 346, 352.

practice i.e. utmost good faith, either by not allowing any remedy when the insured breaches the duty negligently which does no cause actual damage leading the insured to be careless about his duty to act with utmost good faith. For example, had the insured in *The Litsion Pride*<sup>1044</sup> entered the war zone uncovered by the policy negligently and come out successfully within one hour it would have been hard for the insurer to prove damage, effectively encouraging the insured to continue to act negligently, which is inconsistent with the rule of utmost good faith. Or, by allowing harsh remedy of avoidance *ab initio* where the insured acted honestly but the insurer would not have taken the policy had he known before taking it that the risk would be changed at some point during the policy. For example, in *Shaw v Robberds*,<sup>1045</sup> an insurance policy was taken stating that ‘a kiln for drying corn in use’, but the insured in one occasion allowed a third party to dry bark which bears the high risk of fire and eventually caused fire. Assuming that the insurer would not have taken the policy had he known the fact that the bark might be dried in some occasions, he should be allowed to avoid the policy under a contractual remedy even if the insured acted honestly.

Professor Malcolm A Clarke suggested that ‘the insurer should be entitled to charge (retrospectively) a premium that reflects the alteration of risk’.<sup>1046</sup> It is not clear, where the risk is altered for couple of hours or days, how the insurer shall claim the increased premium for that couple of hours or days. The situation would be worse if that alteration of the risk of short period caused the peril requiring the court to decide whether the insurer should be allowed an increased premium from the day of taking policy or the day of actual change of risk. For example, eight months after taking policy the insured changed the risk and within a day of changing the risk the peril occurred. Hence, if the increased premium is allowed from the day of taking policy the insured shall argue that he is over punished by requiring to pay increased premiums for those 8 months when the risk was as stated in the policy. On the other hand the insurer may argue that if the risk were not changed, the peril would not have occurred. Moreover, he would have charged increased premium had he known that the risk would be changed. Consequently, he should be remedied by increased premium from the day of taking policy.

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<sup>1044</sup> *Black King Shipping Corporation and Wayang (Panama) S.A. v Mark Ranald Massie (The ‘Litsion Pride’)* [1985] 1 Lloyd's Rep. 437

<sup>1045</sup> (1837) 6 A. & E. 75.

<sup>1046</sup> Malcolm A. Clarke, *The Law of Insurance Contracts* (6<sup>th</sup> edn, Informa 2009) para 27 1A2.

Further, there is problem of deciding the breach of utmost good faith in the absence of an adequate definition of the term 'utmost good faith' in English law. Considering all these difficulties with the contractual remedy the author concurs with the proposal of Law Commission that the remedy should be specified for a specific breach. The author has already specified, in previous chapter, the duty of the insured during the second stage of the contract and this chapter will recommend the remedies for breach of that specific duty.

The breach at this stage can be categorised in two parts, the duty is breached but no peril has yet occurred and the changed risk breaching the duty causes the peril.

### ***The duty is breached but no peril has yet occurred***

Breach is caused by innocent mistake:

- *The insurer shall not be allowed to any remedy if it is found that a reasonable insurer would have allowed the insured to the alleged change without any increment of the premium.*
  
- *However, if a reasonable insurer would have demanded extra premiums for that change of the circumstances the insurer shall be allowed to that increased premium from the date of the breach.*
  
- *Where the breach is so serious that a reasonable insurer would not have permitted such change or would not have taken the policy had he known that the risk would be changed in such manner, the insurer shall be allowed to cancel the contract from the date of the breach.*<sup>1047</sup>

### **Negligent Breach**

- *If the breach is negligent and a reasonable insurer would not have increased the premium for such change, the insurer shall not be allowed to any remedy.*
  
- *Had a reasonable insurer increased the premium the insurer would be allowed to claim that increased premium from the date of the breach along with the judgment rate interest on that*

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<sup>1047</sup> If this remedy is applied in *Shaw v Robberds* (1837) 6 A. & E. 75 the insurer shall be allowed to cancel the contract from the date of the breach enabling him to avoid the claim. The insured shall also be safe from consequence of the current remedy of avoidance *ab initio*.

*increment from the date of the breach till the date the insurer was informed about the breach. The justification of imposing the interest is that the insured's negligence has deprived the insurer from investing that extra amount for certain period.*

- *If the breach is so serious that a reasonable insurer would not have permitted such change or would not have taken the policy had he known that the risk would be changed in such manner during the policy, the insurer shall be allowed to cancel the contract from the date of the breach and claim judgment rate interest on the premiums paid from the date of the breach till the date the insurer was informed. The justification of imposing the interest is that the insurer has to pay the premiums taken after the day of the breach back to the insured once he cancels the contract. In such case the insurer will lose his administrative costs and also a new client from the day of the alleged breach. Consequently, the said interest is required to compensate him.*

#### Fraudulent Breach

- *If the breach is minor, so that a reasonable insurer would have allowed the change the insurer shall be allowed to either avoid the contract from the date of the breach or continue it by increasing the premium that a reasonable insurer would have increased for such change of the risk along with judgment rate interest on the paid premiums including the increment from the date of the breach till the date he was informed about the breach. The interest is to be paid for a similar reason to that of for negligent breach. However, the amount of interest is higher in this case in order to deter the insured from being fraudulent.*
- *If the breach is of such seriousness that a reasonable insurer would not have allowed the insured to change the risk or would not have taken the policy had he known that the risk would be changed in such manner during the policy, the insurer shall be allowed to avoid the contract ab initio, retaining the premiums with him. The justification of allowing the insurer to keep the premiums is to show the society's disapproval to such fraudulent act.*

#### ***The changed risk breaching the duty causes the peril***

#### Innocent Breach

- *The insurer shall pay the full claim if it is found that a reasonable insurer would have allowed the insured to have that change without asking to increase premium.*

- *If a reasonable insurer would have asked for an increased premium for that change the insurer shall be allowed to have that increment from the date of taking policy and as such shall set aside that amount from the claimed amount.* This remedy is justified on the ground that had he known that the circumstances would be changed in such manner he would have charged that increased premium from the date of taking policy. Since the alleged new risk has caused the peril it is justifiable for him to be where he should have been.
  
- *If the breach is such seriousness that a reasonable insurer would not have taken the policy had he known before making the contract that the risk would be changed in such way during the policy, the insurer shall be allowed to pay 50% of the claim.* This remedy is justified on the ground that the risk that it has been changed to is not supposed to be covered by the insurer. If he is required to pay full claim then it shall be unfair for him. On the other hand if he is allowed to refuse whole claim then it shall be harsh remedy for the insured since the breach happened by an innocent mistake and he may be in serious trouble if he gets nothing, whilst he has always been on an expectation of being recovered if peril occurs and paid premiums in that regard.

#### Negligent Breach

- *If the breach is caused negligently but a reasonable insurer would not have increased premium the insurer shall pay the full claim.*
  
- *If it is found that a reasonable insurer would have increased the premium the insurer shall be allowed to have that increased premium along with interest at the judgment rate on that increment from the date of taking policy and set aside that amount from the claimed amount.* The interest should be paid for aforementioned reasons.
  
- *If the change is of such seriousness that a reasonable insurer would have refused to allow the alleged change or would not have taken the policy had he known that the risk would be changed in such way during the policy, the insurer shall be allowed to pay 25% of the entire claim.* The remedy is very similar to that of innocent breach except the ratio. The insured shall obtain 25% of the claim since he oppressed the insurer by his negligence that caused the peril and also caused him the loss by requiring him to pay the claim that would not have incurred had he not negligently changed the circumstances.

## Fraudulent Breach

- *If the breach is minor, and a reasonable insurer would have allowed the change, then the insurer shall be entitled to avoid the whole claim.* This is justified on the ground that the insured has fraudulently created a circumstance because of which the insurer has to pay the claim. Consequently, gaining the claimed amount would benefit the insured for his fraudulent act. Hence, the insured should not be allowed to have the amount.
- *However, if the breach is of such seriousness that a reasonable insurer would not have taken the policy had he known that the risk would be changed in such way, the insurer shall be allowed to avoid the policy ab initio keeping the premiums with him.* This remedy is imposed to show the society's disapproval to such fraudulent act.

Where the insurer investigates the fraud of an insured and successfully discovers it, the insurer should be allowed to recover the cost of the investigation from the insured as proposed by the Law Commission.

### 7.1.6 Remedy under Shariah Principles

The aforementioned analysis has clarified that English insurance law is unsatisfactory in this area. The remedy is unfair for the insured. The courts, therefore, apply different categories of remedy but none is found to be proportionate. Consequently, these remedies cannot accommodate Islamic principles since Allah (S.W.A) said

والسما رفعها ووضع الميزان . ألا تظفوا فن الميزان. وأقيموا الوزن بالقسط ولا تخسروا الميزان

*And the heaven He raised and imposed the balance. That you not transgress within the balance. And establish weight in justice and do not make deficient the balance.*<sup>1048</sup>

This verse apparently imposes the duty to maintain justice balancing the rights of two parties in a contract. Therefore, the governing law always needs to consider whether the remedy made for a party oppress the other or not. In that effect Prophet Muhammad (PBUH) said that there must not be any oppression.<sup>1049</sup> Currently, English law has failed to create the right balance for both parties and as such it should not be right to apply that law in Islamic

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<sup>1048</sup> *The Holy Quran*, 55:7-9.

<sup>1049</sup> A. A. Muslim, *Sahih Muslim*, (USC Centre for Muslim-Jewish Engagement tr, <<http://www.usc.edu/org/cmje/religious-texts/hadith/muslim/032-smt.php>>) Book 032, Number 6250. Accessed 05/07/2013.

insurance policies. Moreover, there is no remedy suggested against the insured who acts improperly during the policy but no peril occurs. Consequently, a fair judgement is hard to obtain from English law. The author, therefore, recommends fair remedies for English law. This recommended remedy could accommodate Islamic principles but for their operational differences a small change is required for Islamic policies. The change is based on the prohibition of ‘interest’ by Shariah principles. Therefore, the author recommends different remedies for Islamic policies which are similar to that for English insurance policies except in the case of ‘interest’.

***The duty is breached but no peril has yet occurred –***

**Innocent Breach**

- *The insurer shall not be allowed to any remedy if it is found that a reasonable insurer would have allowed the insured to the alleged change without increasing the premium.* Imam Muslim stated that ‘the Holy Prophet (may peace be upon him)... has strongly disapproved all transactions which involve any kind of injustice or hardship to the buyer or the seller’.<sup>1050</sup> Since the insurer has not suffered any loss and the breach is caused by innocent mistake it would be unfair for the insured to be punished in such case. Hence the insurer should not be allowed any remedy.
  
- *If it is found that a reasonable insurer would have demanded extra premiums for the change of the circumstances the insurer shall be allowed to that increased premium from the date of the breach.* Imam Muslim stated that the Prophet Muhammad (PBUH) wanted the seller ‘take his own due and give the buyer what is his’.<sup>1051</sup> It is obvious in this case that the insurer has legitimate interest on the increased premiums following the change of the risk and as such the author proposes to let him have those premiums.
  
- *Where the breach is so serious that a reasonable insurer would not have permitted such change or would not have taken the policy had he known that the risk would be changed in such manner, the insurer shall be allowed to cancel the contract from the date of the breach.* This remedy is justified by the following Hadith:

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<sup>1050</sup> See, Abdul Hamid Siddiqi (tr), *Sahih Muslim* (SH. Muhammad Ashraf, Kashmiri Bazar, Lahore, Pakistan 1973) Vol III, 792.

<sup>1051</sup> See, *ibid* 792.



قَالَ أَبُو هُرَيْرَةَ رَضِيَ اللَّهُ عَنْهُ عَنِ النَّبِيِّ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ لَا تُصَرُّوا الْإِبِلَ وَالْغَنَمَ فَمَنْ  
 ابْتَاعَهَا بَعْدُ فَإِنَّهُ بِخَيْرِ النَّظَرَيْنِ بَعْدَ أَنْ يَحْتَلِبَهَا إِنْ شَاءَ أَمْسَكَ وَإِنْ شَاءَ رَدَّهَا وَصَاعٌ  
 تَمْرٍ

*Narrated by Abu Huraira, The Prophet (PBUH) said, 'Don't keep camels and sheep unmilked for a long time, for whoever buys such an animal has the option to milk it and then either to keep it or return it to the owner along with one Sa of dates.'*<sup>1052</sup>

#### Negligent breach

- *If the breach is negligent and it is found that a reasonable insurer would not have increased the premium for such change the insurer shall not be allowed to any remedy.*<sup>1053</sup> This remedy is similar to that of the remedy for innocent breach. This remedy is also justified by the similar ground to that of for the innocent breach, i.e. it would be unfair for the insured to be required to compensate the insurer who has suffered no loss.

- *Had a reasonable insurer increased the premium the insurer would be allowed to have that increased premium from the date of the breach along with a charge equivalent to the judgment rate interest on that total increment calculating from the date of breach till the date the insurer was informed about the breach.*<sup>1054</sup> The justification of imposing the charge is to compensate the other Takaful participants who were deprived, due to the insured's negligence, from the financial benefit expected from the investment of that extra amount. The reason for considering the judgment rate interest in fixing the amount of charge is to make it English law compliant, which is recommended by the author.

- *If the breach is of seriousness that a reasonable insurer would not have permitted such change or would not have taken the policy had he known that the risk would be changed in such manner during the policy, the insurer shall be allowed to cancel the contract from the date of the breach and retain the total profits on the paid premiums but shall pay the paid premiums, that are paid from the date of the breach, back.*<sup>1055</sup> The insured should not get any part of the profit since the contract would not have existed had he acted reasonably.

<sup>1052</sup> Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari*, No. 2041, M Muhsin Khan (tr) *Sahih Bukhari* Vol 3, Book 34, No. 358. See, *Sunan At-Tirmizi*, Hadith No. 1251.

<sup>1053</sup> See, Abdul Hamid Siddiqi (tr), *Sahih Muslim* (SH. Muhammad Ashraf, Kashmiri Bazar, Lahore, Pakistan 1973) Vol III, Introduction of 'Kitab al-Buyu'.

<sup>1054</sup> See Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari*, No. 2041, M Muhsin Khan (tr) *Sahih Bukhari* Vol 3, Book 34, No. 358. See, *Sunan At-Tirmizi*, Hadith No. 1251; *The Holy Quran*, 11:85.

<sup>1055</sup> See, *ibid*.

Consequently he should not have the profit that he was not supposed to get. He, therefore, should only receive the actual premiums.

#### Fraudulent Breach

- *If the breach is minor, then the insurer shall be allowed to either avoid the contract from the date of the breach or continue it by increasing the premium that a reasonable insurer would have increased for such change of the risk along with a charge equivalent to the judgment rate interest on the paid premiums including the increment from the date of the breach till the date he was informed about the breach.* The charge should be paid for the similar reason to that of for the negligent breach. However, the charge is higher in this case in order to deter the insured from being fraudulent.

- *If the breach is of such seriousness that a reasonable insurer would not have allowed the insured to change the risk or would not have taken the policy had he known that the risk would be changed in such manner during the policy, the insurer shall be allowed to avoid the contract ab initio. If the policy is so avoided the insurer shall pay back the fully paid premiums but not the profits made on those amounts.* This remedy is justified on the ground that the fraud is strictly prohibited in Islam and as such the insurer is allowed avoid the whole contract since this would have been his position had he known the fact before making the contract. The insurer shall pay back the premiums since Prophet Muhammad (PBUH) ordered to pay one Sa of dates for the cost of the milk consumed by the buyer along with the camel where the seller does fraud in transaction.<sup>1056</sup> This remedy shall not contradict with the author's recommended remedy for English insurance law since the insurer has been given choice of retaining the premiums and that choice shall be given up in the case of Islamic policies.

#### ***Breach causing the peril***

##### Innocent breach

- *The insurer shall pay the full claim if it is found that a reasonable insurer would have allowed the insured to have that change without asking to increase premium.*<sup>1057</sup>

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<sup>1056</sup> *ibid.* See also, *The Holy Quran*, 11:85.

<sup>1057</sup> See, Abdul Hamid Siddiqi (tr), *Sahih Muslim* (SH. Muhammad Ashraf, Kashmiri Bazar, Lahore, Pakistan 1973) Vol III, Introduction of 'Kitab al-Buyu'.

- *If it is found that a reasonable insurer would have asked to increase premium for that change, the insurer shall be allowed to have that increment from the date of taking policy and as such shall set aside that amount from the claimed amount.*<sup>1058</sup>

- *If the breach is of such seriousness that a reasonable insurer would not have taken the policy had he known before taking the policy that the risk would be changed in such manner during the policy, the insurer shall be allowed to pay 50% of the claim.*<sup>1059</sup>

These three categories of remedies are similar to that of recommended for the English insurance law and as such their justifications are also similar. It has been argued that these remedies are fair and reasonable. Allah (SWT) and Prophet Muhammad (PBUH) emphasised on the points of making justice, fair treatment and avoiding oppression.<sup>1060</sup> In such case payment of 50% of claim in the case of last category of breach should also be fair for both parties.

#### Negligent breach

- *If the breach is caused negligently but a reasonable insurer would not have increased the premium the insurer shall pay the full claim.*<sup>1061</sup>

- *If it is found that a reasonable insurer would have increased the premium, the insurer shall be allowed to have that increased premium along with a charge equivalent to the judgment rate interest on that increment from the date of taking policy and set aside that amount from the claimed amount.*<sup>1062</sup> The charge should be paid for aforementioned reasons.

- *If the change is of such seriousness that a reasonable insurer would have refused to allow the alleged change or would not have taken policy had he known that the risk would be changed in such manner during the policy, the insurer shall be allowed to pay 25% of the*

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<sup>1058</sup> See, *ibid.*

<sup>1059</sup> Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari*, No. 2041, M Muhsin Khan (tr) *Sahih Bukhari* Vol 3, Book 34, No. 358. See, *Sunan At-Tirmizi*, Hadith No. 1251.

<sup>1060</sup> See, Abdul Hamid Siddiqi (tr), *Sahih Muslim* (SH. Muhammad Ashraf, Kashmiri Bazar, Lahore, Pakistan 1973) Vol III, Introduction of 'Kitab al-Buyu'.

<sup>1061</sup> See, *ibid.*

<sup>1062</sup> The imposition of charge is to recover the insurer from the loss of profit that that he should have gained by investment of those increments. See, Muhammad bin Ismail Al-Mughirah Al-Bukhari, *Sahih Bukhari*, No. 2041, M Muhsin Khan (tr) *Sahih Bukhari* Vol 3, Book 34, No. 358. See, *Sunan At-Tirmizi*, Hadith No. 1251.

*claim.* This remedy is also similar to that of recommended for the English insurance law. Hence, the justification for such remedy is also similar.

#### Fraudulent breach

- *The breach is minor, so that a reasonable insurer would have taken the policy: the insurer shall be allowed to avoid the whole claim.* This is similar to that of the remedy recommended for English insurance law. Consequently, the justification for such remedy is also similar.

- *If the breach is of such seriousness that a reasonable insurer would not have taken the policy had he known that the risk would be changed in such Manner, the insurer shall be allowed to avoid the policy ab initio keeping the profits on the paid premiums and giving the premiums back.* In this case the insurer is allowed to avoid the whole contract since he would not have issued such a policy and shall be allowed to keep the profits as a charge for serving the insured with a policy that he would not have taken but for the fraud. He will pay the premiums back following the requirement imposed by the above-mentioned Hadith.

It is apparent from these recommended remedies for English insurance policies and Islamic insurance policies that they are identical in majority cases. The minor differences that are present are due to their differences in formation. If English law applies the author's recommended remedy the application of Islamic policies shall be much easier. However, the Islamic insurance policies taken under the current English law should incorporate adequate terms giving effect to the recommended remedies so as to make them Shariah compliant.

## **7.2 Breach of Duty by the Insured at the Third Stage of the Contract – The Claim Stage**

### **7.2.1 The Current English Insurance Law**

The making of a fraudulent claim leads the insured to be deprived of dishonest part of the claim as well as the honest part of it.<sup>1063</sup> In the words of Lord Hobhouse: 'The logic is simple. The fraudulent insured must not be allowed to think if the fraud is successful, then I will gain, if unsuccessful, I will lose nothing'.<sup>1064</sup> This is the remedy the courts in recent years are applying against the fraudulent claim evading the statutory remedy of avoidance *ab initio*

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<sup>1063</sup> *Manifest Shipping co Ltd v Uni-Polaris Shipping Co Ltd; The Star Sea* [2001] UKHL 1; [2001] 2 WLR 170 [62] (Lord Hobhouse); *Agapitos v Agnew; The Aegeon* [2002] EWCA Civ 247; [2002] 3 WLR 616 [19], [21], [45] (Mance LJ).

<sup>1064</sup> *ibid* [62]

under section 17. The reasoning is simple, the remedy of avoidance *ab initio* may be appropriate where ‘the want of good faith has preceded and been material to the making of the contract’. But, where the want of good faith occurs later, ‘it becomes anomalous and disproportionate’.<sup>1065</sup> Similar reasoning has been voiced by academics like Eggers, Picken and Foss, who state that avoidance *ab initio* is justified in the pre-contractual context since ‘the claimant’s consent to the contract is vitiated by the non-disclosure or misrepresentation. In the context of a claim, there is no question of the vitiation of consent, since no consent to the formation of a contract has been induced by the fraudulent claim’.<sup>1066</sup>

Until the decision in *The Star Sea*,<sup>1067</sup> the courts had generally approved the accepted notion that in the event of a fraudulent claim the insurer would be entitled to avoid the insurance.<sup>1068</sup> However, such notion was opposed by Sir Roger Parker in *Orakpo v Barclays Insurance Services*,<sup>1069</sup> who held that only the claim itself be forfeited and nothing more. Millett LJ in *Galloway v Guardian Royal Exchange (UK) Ltd*, gave a similar view stating that ‘the right approach in such a case is to consider the fraudulent claim as if it were the only claim and then to consider whether, taken in isolation, the making of that claim by the insured is sufficiently serious to justify stigmatizing it as a breach of his duty of good faith so as to avoid the policy’.<sup>1070</sup>

The courts, however, subsequently suggested that the remedy of avoidance is inappropriate in respect of fraudulent claims,<sup>1071</sup> notwithstanding that the prevention of fraud has been stated to be the purpose of the duty and such harsh remedy.<sup>1072</sup> Lord Hobhouse in *The Star Sea*<sup>1073</sup> held that the common law principle of avoiding entire claim should be applied.<sup>1074</sup> The entire claim including the honest one was allowed to be avoided in *Axa General Insurance Ltd v*

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<sup>1065</sup> *ibid* [51] (Lord Hobhouse), *Fargnoli v GA Bonus Plc* [1997] CLC 653, 670 (Lord Penrose).

<sup>1066</sup> Peter Macdonald Eggers, Simon Picken and Partrick Foss *Good Faith and Insurance Contracts* (2nd edn, LLP 2004) 279.

<sup>1067</sup> *Manifest Shipping co Ltd v Uni-Polaris Shipping Co Ltd; The Star Sea* [2001] UKHL 1; [2001] 2 WLR 170.

<sup>1068</sup> *Orakpo v Barclays Insurance Services* [1995] LRLR 443, 452 (Sir Roger Parker); *Royal Boskalis Westminster NV v Mountain* [1997] LRLR 523, 599, 601 (Rix J); *Galloway v Guardian Toyal Exchange (UK) Ltd* [1999] Lloyd’s Rep IR 209, 214 (Millett LJ); *Manifest Shipping co Ltd v Uni-Polaris Shipping Co Ltd; The Star Sea* [2001] UKHL 1; [2001] 2 WLR 170, [81] (Lord Scott).

<sup>1069</sup> [1994] CLC 373, 385.

<sup>1070</sup> [1999] Lloyd’s Rep IR 209, 214 (Millett LJ).

<sup>1071</sup> Nicholas Legh-Jones QC, John Birds and David Owen (eds), *Macgillivray on Insurance Law* (10<sup>th</sup> edn, Sweet & Maxwell 2003) para 19-59.

<sup>1072</sup> *Galloway v Guardian Royal Exchange (UK) Ltd* [1999] Lloyd’s Rep IR 209, 214.

<sup>1073</sup> *Manifest Shipping co Ltd v Uni-Polaris Shipping Co Ltd; The Star Sea* [2001] UKHL 1; [2001] 2 WLR 170 [62].

<sup>1074</sup> See also Mance LJ in *Agapitos v Agnew, The Aegeon* [2002] EWCA Civ 247, [2003] Q.B. 556 [45].

*Gottlieb*.<sup>1075</sup> This common law principle was analysed as an implied term in *Orakpo v Barclays Insurance Services*.<sup>1076</sup> The court held that fraud went to the root of the contract and therefore entitled the insurers to repudiate it for the future. This approach, however, was not endorsed in *The Star Sea*<sup>1077</sup> and in *Agapitos v Agnew*.<sup>1078</sup> It is apparent from the decision of the House of Lords in *The Star Sea*,<sup>1079</sup> that non-disclosure or misrepresentation at the claims stage does not lead to retrospective avoidance of the contract,<sup>1080</sup> but the court did not rule clearly on the relationship between section 17 and a fraudulent claim. Lord Penrose in the Scottish case *Fargnoli v GA Bonus Plc* stated that ‘a claim tainted by fraud would be cut down as a whole’.<sup>1081</sup> However, the court in *The Mercandian Continent*,<sup>1082</sup> explained above, provided some guidelines detailing when section 17 can be applied. Firstly, if the fraud is such seriousness that it would have an effect on the insurer’s ultimate liability and the gravity of the fraud or its consequence would entitle the insurers to terminate the contract for breach. The Law Commission commented that the ‘requirements are not onerous’ and as such the purpose of limiting the scope of section 17 will not be successful.<sup>1083</sup>

MacGillivray suggests that both the common law and the statutory rules are enforceable and either of them can be invoked by the insurer, causing serious complication in the law.<sup>1084</sup> The Law Commission on the other hand opined that the rule of section 17 remains in theory but not in practice, as such the only remedy applicable in these cases is the forfeiture of the claim.<sup>1085</sup> Professor Malcom A Clarke believes that the entire claim shall be forfeited as well as the insurer shall be entitled to terminate the contract with prospective effect. Any previous outstanding honest claims ‘remain enforceable’ and the insurer is unable to recover any premium paid.<sup>1086</sup> A similar view was adopted by the court in *Axa General Insurance Ltd v*

<sup>1075</sup> [2005] EWCA Civ 112, [2005] Lloyd’s Rep IR 369.

<sup>1076</sup> [1994] CLC 373.

<sup>1077</sup> *Manifest Shipping co Ltd v Uni-Polaris Shipping Co Ltd; The Star Sea* [2001] UKHL 1; [2001] 2 WLR 170.

<sup>1078</sup> [2002] EWCA Civ 247, [2003] Q.B. 556.

<sup>1079</sup> *Manifest Shipping co Ltd v Uni-Polaris Shipping Co Ltd; The Star Sea* [2001] UKHL 1; [2001] 2 WLR 170.

<sup>1080</sup> Disapproving the decision to the contrary in *The Litsion Pride* [1958] 1 Lloyd’s Rep. 437, 514-516.

<sup>1081</sup> [1997] CLC 653, 670 (rejecting an earlier obiter view to the contrary by Lord Trayner in *Reid & Co v Employers’ Accident & Live Stock Insurance Co* (1899) 1 F 1031, 1037).

<sup>1082</sup> *K/S Merc-Scandia v Certain Lloyd’s Underwriters* [2001] EWCA Civ 1275, [2001] 2 Lloyd’s Rep. 563 [35] (Longmore LJ).

<sup>1083</sup> Law Commission and Scottish Law Commission *The Insured’s Post-Contract Duty of Good Faith* (Issues Paper 7, July 2010) para 2.19; Nicholas Legh-Jones QC, John Birds and David Owen (eds), *Macgillivray on Insurance Law* (11<sup>th</sup> edn, Sweet & Maxwell 2008) para 19-065.

<sup>1084</sup> Nicholas Legh-Jones QC, John Birds and David Owen (eds), *Macgillivray on Insurance Law* (11<sup>th</sup> edn, Sweet & Maxwell 2008) para 19-055.

<sup>1085</sup> Law Commission and Scottish Law Commission *The Insured’s Post-Contract Duty of Good Faith* (Issues Paper 7, July 2010) para 2.23.

<sup>1086</sup> Malcolm A. Clarke, *The Law of Insurance Contracts* (6<sup>th</sup> edn, Informa 2009) para 27-2C3

*Gottlieb*<sup>1087</sup> and by the FOS.<sup>1088</sup> Mance LJ, on the other hand, in *Agapitos v Agnew*,<sup>1089</sup> divided a fraudulent claim into two parts, the ‘material fraud’ and ‘fraudulent devices’. He suggested that in both cases the common law rule of forfeiture of the whole claim should be applied and that this is ‘outside the scope of s.17’.<sup>1090</sup> The Law Commission support the current view of the courts that apply the common law remedy in this way.<sup>1091</sup> The common law rule shall be applied where the assured’s fraud, which is made deliberately or recklessly to promote claim,<sup>1092</sup> relate to a substantial and not trivial part of the claim<sup>1093</sup> and be material to the claim.<sup>1094</sup> MacGillivray states that when the common law rule applies ‘the assured automatically forfeits his whole claim’.<sup>1095</sup>

In a similar manner to the English courts, the Scottish courts in *Fargnoli v GA Bonus Plc*<sup>1096</sup> applied the remedy of rescission instead of avoidance, but on different ground, namely breach of mutual good faith.<sup>1097</sup> Lord Penrose observed that under the duty of mutual good faith, avoidance could not be the remedy for all breaches of good faith, since the insured would rarely have anything to gain from avoidance.<sup>1098</sup> The Law Commission regretted for the courts in English cases not considering this view since it is ‘a helpful way to conceptualise the duties’.<sup>1099</sup>

According to Malcolm A Clarke the insurer is entitled to recover damages for the ‘wasted’ cost of investigating the fraudulent aspects of the claim due to the breach of the implied duty of co-operation.<sup>1100</sup> By contrast, in *London Assurance v Clare*,<sup>1101</sup> Goddard J refused a claim for damages for the cost of investigating a fraudulent claim argued on the basis of breach of

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<sup>1087</sup> [2005] EWCA Civ 112; [2005] 1 All ER (Comm) 445.

<sup>1088</sup> *Ombudsman News*, (Issue 41, November 2004) p. 3.

<sup>1089</sup> [2002] EWCA Civ 247, [2003] Q.B. 556.

<sup>1090</sup> *ibid* [45].

<sup>1091</sup> Law Commission and Scottish Law Commission *The Insured’s Post-Contract Duty of Good Faith* (Issues Paper 7, July 2010) para s.19.

<sup>1092</sup> *Wisenthal v World Auxiliary Insurance Corporation Ltd* (1930) 38 Ll L Rep 54; *Derry v Peek* (1889) LR 14 App Cas 337; *Agapitos v Agnew* [2002] EWCA Civ 247, [2003] Q.B. 556 [37].

<sup>1093</sup> *Galloway v Guardian Royal Exchange (UK) Ltd* [1999] Lloyd’s Rep. I.R. 209, 212, 214; *Lek v Mathews* (1927) 29 Lloyd’s Rep. 141, 145; *Agapitos v Agnew* [2003] Q.B. 556, 570 [33].

<sup>1094</sup> *Lek v Mathews* (1927) 29 Lloyd’s Rep. 141, 145; *Agapitos v Agnew* [2003] Q.B. 556, 570 [38].

<sup>1095</sup> Nicholas Legh-Jones QC, John Birds and David Owen (eds), *Macgillivray on Insurance Law* (11<sup>th</sup> edn, Sweet & Maxwell 2008) para 19-063.

<sup>1096</sup> [1997] CLC 653.

<sup>1097</sup> *ibid* 670.

<sup>1098</sup> *ibid* 670.

<sup>1099</sup> Law Commission and Scottish Law Commission *The Insured’s Post-Contract Duty of Good Faith* (Issues Paper 7, July 2010) para 4.56.

<sup>1100</sup> Malcolm A. Clarke, *The Law of Insurance Contracts* (6<sup>th</sup> edn, Informa 2009), para 27-2C5

<sup>1101</sup> (1937) 57 Ll L Rep 254

an implied term on the grounds that it was too remote.<sup>1102</sup> Clarke argues that this reasoning ‘cannot stand with the modern contract law’.<sup>1103</sup> In favour of his argument he referred to the decision of the New Zealand courts in *Back v National*,<sup>1104</sup> when the claim for damages based on the tort deceit succeeded.

### 7.2.2 The Approach of the Law Commission

No innovative guideline was proposed by the Law Commission. Instead, they suggested statutory reform providing for flexible and appropriate remedies. The remedies adopted by the courts, such as forfeiture of the claim, are appropriate in their view.<sup>1105</sup> They suggested retaining the remedy for breach of ‘mutual good faith’,<sup>1106</sup> as identified by the Scottish court in *Fargnoli v GA Bonus Plc*.<sup>1107</sup> They are also of the opinion of allowing damages for investigations of fraudulent claims, as the cost is reasonable and foreseeable for which the insurer is not compensated.<sup>1108</sup>

### 7.2.3 The Legal Position in Australia

Section 56 (1) of Insurance Contract Act 1984 states that the insurer shall not be allowed to avoid the contract, but may refuse the whole claim affected by the fraud.<sup>1109</sup> However, if the court considers that the fraudulent amount represents a minimal or insignificant part of the claim meaning that a refusal of the whole claim would be harsh or unfair, the court may ‘order the insurer to pay, in relation to the claim, such amount (if any) as is just and equitable in the circumstances’.<sup>1110</sup> Section 56 (3) provides that in exercising this discretion the court shall have regard to the need to deter fraudulent conduct in relation to insurance, but may also have regard to any other relevant matter. Section 60 (1) (e) of the Act allows the insurer to cancel both the contract and any other policy in operation at the same time.

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<sup>1102</sup> *ibid* 270.

<sup>1103</sup> Malcolm A. Clarke, *The Law of Insurance Contracts* ((6<sup>th</sup> edn, Informa 2009), para 27-2C5

<sup>1104</sup> [1996] 3 NZLR 363.

<sup>1105</sup> Law Commission and Scottish Law Commission *The Insured’s Post-Contract Duty of Good Faith* (Issues Paper 7, July 2010) para 2.28.

<sup>1106</sup> *ibid* paras 2.28, 4.81

<sup>1107</sup> [1997] CLC 653.

<sup>1108</sup> Law Commission and Scottish Law Commission *The Insured’s Post-Contract Duty of Good Faith* (Issues Paper 7, July 2010) para 7.41.

<sup>1109</sup> The Insurance Contracts Amendment Bill 2013 has proposed to include section 59A allowing the insurer to cancel the life insurance contract for fraudulent claim and also empowering the court to disregard the cancellation where it would be harsh and unfair if they do not do so.

<sup>1110</sup> Section 56 (2) of Insurance Contracts Act 1984.



#### **7.2.4 Critical Analysis of Australian Law**

The remedy provided by the Act is considered to be sound by the courts and academics, but the allowance of the discretion by the court to pay the justifiable amount where the fraudulent amount is nominal, is criticised by the Law Commission on the ground that this ‘might be seen to encourage policyholders to commit minor frauds in the expectation that such conduct would not affect the legitimate element of the claim’.<sup>1111</sup> The condition of substantiality of fraud is, however, also applied by the courts under common law. The yardstick for determination of substantiality was determined by Lord Wolf M.R as 10% of whole claim in *Galloway v Guardian Royal Exchange (UK) Ltd.*<sup>1112</sup> This yardstick has been criticised by Millet LJ in the same case on the ground that this would lead to the absurd result that the greater the genuine loss, the more fraudulent the claim could be without penalty. Subsequent cases have not addressed this issue.

#### **7.2.5 Critical Analysis and Recommendation**

It is apparent that the courts experience difficulties in determining the exact duty of the insured and its remedy. However, in recent years the courts have agreed on the point that the duty is not to make fraudulent claim and the remedy is forfeiture of the whole claim with the choice of cancellation of the contract. The Law Commission have agreed with this approach.

In the previous Chapter the author has criticised the current approach of imposing the mere duty of refraining from making fraudulent claim. In his view there should be separate duty relating to device and claim. Consequently, there should be remedy for breach of those duties, which are outlined below.

##### ***The Breach Relating to Device***

###### **Innocent Breach**

*- If the insured fails to handle the devices with utmost good faith due to innocent mistake the insurer shall not be allowed to any remedy.*

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<sup>1111</sup> Law Commission and Scottish Law Commission, *The Insured's Post-Contract Duty of Good Faith* (Issues Paper 7, July 2010) para 4.73; R Merkin, ‘Reforming Insurance Contract Law: Is There A Case for Reverse Transportation?’ (2007) para 6.11 <[http://www.justice.gov.uk/lawcommission/docs/ICL\\_Merkin\\_report.pdf](http://www.justice.gov.uk/lawcommission/docs/ICL_Merkin_report.pdf)> accessed, 4 November 2011.

<sup>1112</sup> [1999] Lloyd’s Rep. I.R. 209

### Negligent Breach

- *If the breach is negligent the insurer shall be placed in the position where he would have been had there been no breach. For example, the insured has to pay the cost of part of the investigation that the insurer would not have investigated had there been no breach.*

### Fraudulent Breach

- *In the case of fraudulent breach the whole claim shall be forfeited and the insurer shall be entitled to cancel the contract with prospective effect and any other policy in operation at the same time, in order to enable the insurer to avoid any contractual relationship with that fraudulent policyholder.*

### **The Breach Relating to the Claim**

#### Innocent Breach

- *The insurer shall not have any remedy for innocent breach by the insured except avoiding the excess amount.*

#### Negligent Breach

- *If the breach is negligent the insured has to pay interest at judgment rate on the excess amount from the date of the claim till the date of its detection. The insurer shall be allowed to avoid the excess amount claimed.*

#### Fraudulent Breach

- *If the breach is fraudulent and the fraudulent part of the claim is trivial the court shall have discretion to require the insurer to pay the amount that is just and equitable according to the circumstances. The insured however has to pay the full cost of the investigation and the interest at judgment rate on the excess amount from the date of the breach till the date of detection.*
- *If the fraudulent part of the breach is found not to be trivial the whole claim shall be forfeited and the insurer shall be allowed to cancel that contract and any other policy with him at the same time with prospective effect. The insured shall also pay the cost of investigation.*

### 7.2.6 Remedy under Shariah Principles

It has already been clarified that the current duty of the insured at the claim stage (discussed in chapter 6) and its remedy for breach in English insurance law is narrow and inadequate. The author therefore has recommended reasonable and proportionate duties of the insured (in chapter 6) and the remedy for their breach. The author has also analysed (in chapter 6) that the recommended duty for English insurance law can accommodate Islamic principles. The remedy recommended for English insurance contracts can also accommodate Islamic principles except the ‘interest’. To avoid the provision of interest the Islamic insurers should incorporate a term changing the interest rate to a fixed charge equivalent to the judgment rate interest. Until English insurance law adopts the author’s recommended remedy an Islamic insurer should incorporate adequate terms giving effect to that remedy.

## 7.3 Breach of Duty by the Insurer at the Third Stage of the Contract – The Claim Stage

### 7.3.1 The Current English Insurance law

The duty of an insurer at the claim stage, as it is recognised in English law, is only to observe utmost good faith (discussed in chapter 6). Though the duty sounds very heavy and efficient, it is actually very light and inadequate in practice due to the suicidal remedy imposed by section 17, which is avoidance of the contract by the insured. It is clear from the aforementioned analysis that the courts have developed the duty of the insured and remedy for its breach in a different angle that evades the statutory effect but has failed to do the same for the insured as against the insurer.<sup>1113</sup> For example, Clarke LJ said in *Drake Insurance plc v Provident Insurance plc*<sup>1114</sup> that ‘there is at present (so far as I am aware) no authority for the proposition that an insurer owes the insured a duty to take reasonable care to make appropriate inquiries before avoiding the policy’.

However the issue has been raised in some cases like *Banque Financière de la Cité SA v Westgate Insurance Co*,<sup>1115</sup> where the insured claimed that the insurer breached the duty of utmost good faith. In the High Court, Steyn J held that the remedy was not restricted to avoiding of the contract and claiming the return of the premium but also entitle him to claim damages for losses incurred for that breach.<sup>1116</sup> However, the Court of Appeal<sup>1117</sup> (with the

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<sup>1113</sup> See, Law Commission and Scottish Law Commission, *Damages for Late Payment and the Insurer’s Duty of Good Faith* (Issues Paper 6, 2010) para s.33.

<sup>1114</sup> [2003] EWCA Civ 1834; [2004] 1 Lloyd’s Rep 268 [145]

<sup>1115</sup> [1987] 2 W.L.R. 1300.

<sup>1116</sup> *ibid* 1332-1333.

approval of the House of Lords),<sup>1118</sup> rejected this approach holding that the remedy is restricted to avoiding the contract by the insured.

In *Insurance Corporation of the Channel Islands Ltd and Another v McHugh and Royal Hotel Limited*,<sup>1119</sup> the insured made a counter claim alleging that the insurer breached his duty to act with utmost good faith by plotting to injure the policyholder by way of ‘defeating or reducing Royal Hotel’s rights under the policies and by delaying making payment.’ Following *Banque Financière de la Cité SA v Westgate Insurance Co*,<sup>1120</sup> Mance J held that the remedy is restricted to avoidance of the contract and to recovery of premiums. The policyholder also raised the issue of an implied duty that requires the insurer to ‘conduct the negotiations after the occurrence of an insured event and/or assess the amount of and/or pay the sums due under the material damage and/or business interruption policy with reasonable diligence and due expedition’, which the insured claimed the insurer has breached. Mance J also rejected such duty resulting no other remedy for the insured. In *Sprung v Royal Insurance (UK)*<sup>1121</sup> the peril occurred in April 1986 upon which the insured made a claim, which was refused by the insurer. The insured commenced proceedings, but the insurer subsequently withheld their defence in March 1990 and agreed to pay the claim. Meanwhile, the insured went out of business due to the lack of money suffering an uninsured loss of £75,000. The court awarded the insured an indemnity for his lost plant and machinery plus simple interest and costs, but rejected the claim for the uninsured loss caused by delayed payment on the ground that ‘an assured has no cause of action for damages for non-payment of damages’.<sup>1122</sup> Following the decision in *Ventouris v Mountain (The Italia Express (No. 2))*<sup>1123</sup> the court held that the insurer was in breach of contract the moment the insured loss occurred and as such he was liable to pay that damage but there was no obligation to pay within a reasonable time.<sup>1124</sup> If the insurer delays the payment knowing the claim is valid to have their own financial gain, Mance J in *McHugh* held that, the insured could still not recover any damages.<sup>1125</sup> This decision was affirmed in *Normhurst Ltd v Dornoch Ltd*,<sup>1126</sup>

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<sup>1117</sup> [1990] 1 Q.B. 665

<sup>1118</sup> [1991] 2 A.C. 249

<sup>1119</sup> [1997] LRLR 94.

<sup>1120</sup> [1990] 1 Q.B. 665

<sup>1121</sup> [1997] CLC 70.

<sup>1122</sup> *ibid* 75 (Evans LJ), 80 (Beldam LJ); *President of India v Lips Maritime Corp* [1988] AC 395, 425 (Lord Brandon).

<sup>1123</sup> [1992] 2 LI Rep 281; *President of India v Lips Maritime Corp* [1988] AC 395, 424 (Lord Brandon).

<sup>1124</sup> *Insurance Corporation of the Channel Islands Ltd v McHugh* [1997] LRLR 94, 136.

<sup>1125</sup> *ibid* 137-138.

which held that the insured would not have any damages for being insolvent due to the wrongful refusal to pay the valid claim by the insurer. However, Evans LJ in *Sprung* stated that the parties could include such duty by express term.<sup>1127</sup> The court found that the insurer breached his duty of utmost good faith in handling the claim in *The Grecia Express*,<sup>1128</sup> but failed to suggest any remedy for breach of that duty. In *Drake Insurance plc v Provident Insurance plc*<sup>1129</sup> the Court of Appeal recognised the breach of duty of utmost good faith by the insurer by unreasonably denying the claim but failed to award the insured any remedy except preventing the insurer from avoiding the contract and requiring him to pay the claim.

However, four different categories of remedies are available for handling the claim in unfair manner:

- (1) Statutory interest on the claimed amount for late payment.
- (2) Two categories of remedies of FSA for breaching FSA rules of fairly handling the claim. These are any disciplinary action taken by the FSA against the insurer for breaching FSA rules, with the possibility of the imposition of a fine,<sup>1130</sup> and policyholders may bring a claim for damages for breach of statutory duty under section 150 of the Financial Services and Markets Act 2000.
- (3) If the insurer makes a false statement of existing fact, for example, the property worth less than it really is, intending the insured relies on it and the insured accepts lower payment relying on it, the insured shall be placed where he would have been had there been no fraudulent statement under the rule of tort of deceit.<sup>1131</sup>
- (4) Where the policy requires the insurer to reinstate the property, but the insurer fails to reinstate with the quality that it should have done,<sup>1132</sup> the insured then may either reject the

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<sup>1126</sup> [2004] EWHC 567 (Comm); [2005] Lloyd's Rep. I.R. 27.

<sup>1127</sup> *Sprung v Royal Insurance (UK)* [1999] 1 Lloyd's Rep IR 111; [1997] CLC 70, 76.

<sup>1128</sup> *Strive Shipping Corporation and another v Hellenic Mutual War Risks Association ('The Grecia Express')* [2002] EWHC 203 (Comm); [2002] 2 Lloyd's Rep 88, 133 (Colman J); *Gan Insurance v Tai Ping Insurance (No 2)* [2001] EWCA Civ 1047; [2001] CLC 1103, [68] [76]; *Eagle Star Insurance Co Ltd v Cresswell* [2004] EWCA Civ 602; [2004] 1 CLC 926, [54] (Rix LJ).

<sup>1129</sup> [2003] EWCA Civ 1834; [2004] 1 Lloyd's Rep 268.

<sup>1130</sup> Financial Services and Markets Act 2000, S.66.

<sup>1131</sup> *Hadley v Baxendale* (1854) 9 Exch 341.

<sup>1132</sup> *Anderson v Commercial Union Assurance Corp* (1885) 55 LJQB 146, 148 (Lord Esher MR); *Brown v Royal Ins Co* (1859) 1 EI & EI 853; *Argy Trading Development Co Ltd v Lapid Developments Ltd* [1977] 1 Lloyd's Rep 67, 74 (Croom-Johnson J).

reinstatement, or accept it,<sup>1133</sup> and claim damages.<sup>1134</sup> If the bad or slow workmanship of reinstatement causes distress and inconvenience the court may award damages. In *AXA Insurance UK v Cunningham Lindsey UK*<sup>1135</sup> the insured claimed £92,000 for such distress and inconvenience. Akenhead J rejected the amount and allowed £1,800 per person per year. He noted that the authorities suggested a maximum of around £2,000 per person per year for inconvenience and distress. However, where distress or inconvenience is caused due to the failure of paying the claim the courts refused to grant redress.<sup>1136</sup>

The FOS has discretion to hear complaints from both consumers and small business whose annual turnover is less than €2 million and have less than ten employees.<sup>1137</sup> Section 228 (2) of Financial Services and Markets Act 2000 requires the FOS to decide disputes ‘by reference to what is in the opinion of the ombudsman, fair and reasonable in all the circumstances of the case’. Finding the current law unfair and unreasonable in several points the FOS adopted their own remedies. For example, following the court rules the FOS impose interest on the claimed amount at the rate of 8 percent per year ‘from the date of the incident until the date when payment is made’.<sup>1138</sup> Also, the FOS can require reparation for distress and inconvenience caused by mishandling a claim. The reparation can range from an order to send flowers, to a significant award of between £300 and £999 or a sum exceeding £1000 in exceptional cases.<sup>1139</sup> Finally, the FOS can award compensation for financial losses caused by delayed payment, non-payment, poor claims handling or a poor repair.<sup>1140</sup>

In summary, the insured has the remedy to avoid the contract under section 17 if the insurer breaches his duty at the claim stage. The duty at the claim stage has not been defined by the Act. Consequently, the courts are confused how to apply this remedy which is suicidal for the insured. In several cases the insureds claimed damages raising the issue of breach of either

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<sup>1133</sup> *Braithwaite v Employers' Liability Assurance Corp* [1964] 1 Lloyd's Rep 94.

<sup>1134</sup> If the insurer elects to reinstate, the insurance policy is treated as if it had always been a contract for reinstatement. See, *Brown v Royal Ins Co* (1859) 1 EI & EI 853; *Home District Mutual Insurance Co v Thompson* (1847) 1 UC Er & App 247.

<sup>1135</sup> [2007] EWHC 3023 (TCC)

<sup>1136</sup> *Ventouris v Mountain ('The Italia Express')* (No 3) [1992] 2 Lloyd's Rep 281, here the assured was a company; *England v Guardian Insurance Ltd* [1999] 2 All ER (Comm) 481, here the assured was a consumer.

<sup>1137</sup> FSA Handbook, DISP 2.7.3.

<sup>1138</sup> *Ombudsman News* (Issue 33, November 2003) <<http://www.financial-ombudsman.org.uk/publications/ombudsman-news/33/awards-33.htm>> accessed 15 March 2011.

<sup>1139</sup> FOS, Technical note <[http://www.financial-ombudsman.org.uk/publications/technical\\_notes/distress-and-inconvenience.htm](http://www.financial-ombudsman.org.uk/publications/technical_notes/distress-and-inconvenience.htm)> accessed 15 March 2011.

<sup>1140</sup> See, Law Commission and Scottish Law Commission, *Damages for Late Payment and the Insurer's Duty of Good Faith* (Issues Paper 6, 2010) paras 6.5 – 6.16.

utmost good faith or implied duty but the courts strongly opposed the remedy and also opposed any implied duty. In some cases the courts have rejected the claimed remedy of insurer for his breach of utmost good faith but no positive remedy was awarded for the insured against the insurer for that breach.<sup>1141</sup> Accordingly, the insured has no effective remedy in practice against any sort of breach by the insurer at the claim stage.<sup>1142</sup> FOS on the other hand deal with the matters in opposite way by awarding damages. If the leading case *Sprung*<sup>1143</sup> had been decided by FOS, it is assumed that, the insured would have received uninsured losses for delayed payment. It is therefore apparent that there are two categories of rules are existed in one legal system creating complications for the parties.

### 7.3.2 Criticisms of the Current Law

The current law has been heavily criticised by the courts and academics. The judges who took the unfair decision in *Sprung*<sup>1144</sup> criticised the law for not being able to award the uninsured damages. Beldam LJ said, that there ‘will be many who share Mr Sprung’s view that in cases such as this such an award [i.e. mere interest] is inadequate to compensate him...early consideration should be given to reform of the law’.<sup>1145</sup> Reaching the same conclusion ‘with undisguised reluctance’, Evans LJ said, ‘I do not find the defendant’s [i.e. insurers] submissions at all attractive, either from a commercial or from a moral point of view’.<sup>1146</sup> In *Mandrake*,<sup>1147</sup> being bound by the authorities, Rix LJ applied the decision of *Sprung*,<sup>1148</sup> but expected that the House of Lords would revisit the area of law. In March 2001, Longmore LJ gave the Pat Saxton Memorial Lecture,<sup>1149</sup> in which he invited the Law Commission to consider the issue of delayed payment of valid claims by insurers and its remedy.

Academics like John Birds commented that, ‘decision illustrates quite starkly that something needs to be done to remedy insurance law when the insured has no bargaining strength or

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<sup>1141</sup> see for instance, *Drake Insurance v Provident Insurance plc* [2003] EWCA Civ 1834, [2004] Lloyd’s Rep I.R 277

<sup>1142</sup> See, William J. Perry and Heidi Nash-Smith, ‘Drake v Provident’s Effect on Insurers’ Duty of Good Faith in English Law’ (2005) *Defence Counsel Journal* 298, 304.

<sup>1143</sup> *Sprung v Royal Insurance (UK)* [1999] 1 Lloyd’s Rep IR 111; [1997] CLC 70.

<sup>1144</sup> *ibid.*

<sup>1145</sup> *ibid* 80.

<sup>1146</sup> *ibid* 79; *Wallis v Smith* (1882) 21 Ch. D. 243, 257 (Sir George Jessel MR).

<sup>1147</sup> *Mandrake Holdings Ltd v Countrywide Assured Group plc* [2005]EWCA Civ 840, [25].

<sup>1148</sup> *Sprung v Royal Insurance (UK)* [1999] 1 Lloyd’s Rep IR 111; [1997] CLC 70.

<sup>1149</sup> Sir Andrew Longmore, ‘An Insurance Contracts Act for a new century?’ delivered at the invitation of the British Insurance Law Association Trust (5 March 2001).

resources to compete with an insurer'.<sup>1150</sup> He further said that 'there should be such a remedy [damages] where an insurer repudiates or refuses to admit liability without reasonable grounds...this another area of insurance law where statutory reform is needed'.<sup>1151</sup> John Lowry and Philip Rawlings commented that

The deficiencies in the existing remedies for the commercial insured as well as the desirability of a coherent legal regime point to the need for a root-and-branch reform of the law. At the minimum, it requires the English judiciary to take a broader view of the duty of utmost good faith by giving full effect to the reciprocity of the doctrine... there are several models from which the English common law could chose: the law relating to fiduciaries, tort and contract<sup>1152</sup>

Malcolm A Clarke suggested to disregard *Sprung*,<sup>1153</sup> branding it a 'blot on English common law jurisprudence', and recommended<sup>1154</sup> to treat the claimed amount as debt applying the decision of House of Lords in *Sempra*.<sup>1155</sup> Criticising the current remedy and the law to the US and Canada, Al-Asady suggested to have a law that would encourage good faith practice, efficient claims-handling, and deter the inefficient and unreasonable insurer.<sup>1156</sup> She stated that it 'is common sense and practical commercial reality that, in the event of delayed payment, the insurer should be sued for failing to provide peace of mind and compensating for the insured loss'.<sup>1157</sup> She recommended that the 'insurer should then be entitled to recover the amount under the policy (the debt) and claim for the inconvenience caused in the form of aggravated damages with a further option for the court to award punitive damages as a deterrent in serious cases'.<sup>1158</sup> She further recommended that the insured should be 'entitled to sue for policy monies and additional damages from the insurer for inconvenience and distress'.<sup>1159</sup>

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<sup>1150</sup> J R Birds, 'Case Comment: No damages remedy when insurers unjustifiably repudiate liability' [1997] JBL 368, 369; Colin Ying 'Damages for late payment of insurance claims' (2006) LQR 205, 207.

<sup>1151</sup> *ibid* 371.

<sup>1152</sup> John Lowry and Philip Rawlings 'Insurers, Claims and the Boundaries of Good Faith' (2005) 68(1) MLR 82, 109.

<sup>1153</sup> *Sprung v Royal Insurance (UK)* [1997] CLC 70.

<sup>1154</sup> Malcolm Clarke 'Compensation for failure to pay money due: a 'blot on English common law jurisprudence' partly removed' (2008) JBL 291, 294, 303.

<sup>1155</sup> *Sempra Metals Ltd (formerly Metallgesellschaft Ltd) v Inland Revenue commissioners* [2007] UKHL 34; [2008] 1 AC 561.

<sup>1156</sup> Janan Al-Asady, 'Damages, late payment and indemnity insurance' [2006] JBL 396, 404, 406. 407.

<sup>1157</sup> *ibid* 406.

<sup>1158</sup> *ibid* 406.

<sup>1159</sup> *ibid* 406.



### 7.3.3 The approach of the Law Commission

The Law Commission in their issues paper 6 considered the remedy for breach of insurer's duty at the claim stage.<sup>1160</sup> They criticised the current English law on four grounds:<sup>1161</sup> 1) The decisions in *Sprung*<sup>1162</sup> and *Banque Financiere*<sup>1163</sup> are unreasonable, lack principle and undermine the rule of good faith. 2) The automatic rejection of damages without considering the merit of the case is unfair. 3) The current law is eventually rewarding inefficiency and dishonesty. 4) The law is causing injustice to the parties who are unable to bring the case to FOS.

Although there are some alternative remedies available, the Law Commission criticised it for being inefficient. They said:

[W]e think that these remedies will only apply in very specific circumstances and only to a limited range of claimants. A claim for breach of statutory duty, for example, is only open to consumers and not to businesses. Similarly, the tort of deceit or the delict of fraud would only be available to policyholders in very particular (and unusual) situations. We think that in the vast majority of cases, policyholders who have suffered loss due to a late or non-payment will have no effective remedy under English law.<sup>1164</sup>

The Law Commission found the Scottish approach correct. This follows the ordinary contract law principles where an insurer is under an implied duty to pay a valid claim after a reasonable time for investigation.<sup>1165</sup> They are of the opinion that damages should be allowed for foreseeable losses caused by the insurer's breach by acting in bad faith in refusing a valid claim or delaying payment.<sup>1166</sup> The general principle of *Hadley v Baxendale*<sup>1167</sup> should be followed to determine the losses that are foreseeable. The insured also needs to show that he has taken all reasonable steps to mitigate the loss. The second remedy they offered<sup>1168</sup> is to reverse the decision in *Sprung*<sup>1169</sup> and, following the Scottish approach, to impose a strict

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<sup>1160</sup> Law Commission and Scottish Law Commission, *Damages for Late Payment and the Insurer's Duty of Good Faith* (Issues Paper 6, 2010).

<sup>1161</sup> *ibid* paras 8.20 – 8.32.

<sup>1162</sup> *Sprung v Royal Insurance (UK)* [1997] CLC 70.

<sup>1163</sup> [1987] 2 W.L.R. 1300.

<sup>1164</sup> Law Commission and Scottish Law Commission, *Damages for Late Payment and the Insurer's Duty of Good Faith* (Issues Paper 6, 2010) para 5.50.

<sup>1165</sup> *ibid*, para 8.34.

<sup>1166</sup> *ibid*, paras 9.3, 9.26, 9.27.

<sup>1167</sup> (1854) 9 Exch 341.

<sup>1168</sup> Law Commission and Scottish Law Commission, *Damages for Late Payment and the Insurer's Duty of Good Faith* (Issues Paper 6, 2010) paras 9.4, 9.42.

<sup>1169</sup> *Sprung v Royal Insurance (UK)* [1997] CLC 70.

duty to pay valid claims and allow damages for any foreseeable losses if insurer breaches that duty. If the insurer refuses the claim on a reasonable ground but later the claim appears to be valid, the insurer shall still be liable to damages. However, this second remedy can be limited by an express term (as discussed in the previous chapter).<sup>1170</sup>

In the case of consumers' distress and inconvenience the Law Commission closely followed the approach of FOS.<sup>1171</sup> As it is stated above, the FOS allows damages for distress and inconvenience caused by both delayed or poor reinstatement and late payment. The amount that FOS allow as damages is also supported by the Law Commission.

### 7.3.4 The Legal Position in Australia

As discussed above, section 13 of the Insurance Contracts Act 1984 made the duty to observe utmost good faith implied in a contract. Consequently, damages and specific performance are available for breach of utmost good faith during the claim procedure.<sup>1172</sup> In *Moss v Sun Alliance*,<sup>1173</sup> the insurer's grounds for denying the claim were found to be baseless, meaning that the insured was entitled to damages caused by the delay. In *Tropicus Orchids v Territory Insurance Office*,<sup>1174</sup> a business interruption insurer was late in payment and the policyholder recovered the cost of borrowing from a bank to keep his business going until the insurer paid. Such contractual remedies available under section 13 are considered to be adequate.<sup>1175</sup> However, to obtain damages it is necessary to establish that 'the loss sustained was a natural or usual consequence of the breach or, that it was within the contemplation of the parties at the time the contract was formed that such a loss was a probable consequence of the breach'.<sup>1176</sup>

The insured is also entitled to interest for late payment from the day it has become unreasonable for the insurer to withhold payment until the day payment is made or sent by post, whichever is earlier by virtue of section 57 of Insurance Contracts Act 1984.

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<sup>1170</sup> Law Commission and Scottish Law Commission, *Damages for Late Payment and the Insurer's Duty of Good Faith* (Issues Paper 6, 2010) para 9.5.

<sup>1171</sup> *ibid*, paras 9.59 – 9.63.

<sup>1172</sup> See Matthew Ellis, 'Utmost good faith: The scope and application of s 13 of the Insurance Contracts Act in the wake of *CGU v AMP*' (2009) 20 ILJ 92, 110.

<sup>1173</sup> (1990) 6 ANZ Ins Cases 60-967,

<sup>1174</sup> (1998) 148 FLR 441 (NT).

<sup>1175</sup> F Hawke, 'Utmost Good Faith -- what does it really mean?' (1994) 6 ILJ 91, 142.

<sup>1176</sup> Matthew Ellis, 'Utmost good faith: The scope and application of s 13 of the Insurance Contracts Act in the wake of *CGU v AMP*' (2009) 20 ILJ 92, 110.

Section 14A of the Act empowers the Australian Securities and Investments Commission (ASIC) to vary, suspend or cancel the license of the insurer failing to observe the duty of utmost good faith in handling claim.<sup>1177</sup> The section also empowers the ASIC to ban the insurer upon its discretion under Subdivision A of Division 8 of part 7.6 of the Act.

### **7.3.5 Critical Analysis and Recommendation**

It is apparent from the aforementioned analysis that the English law regarding the remedy against the insurer for breach of duty at the claim stage is inadequate and unfair in the eyes of both academics and the courts. In an attempt to introduce a fair and adequate remedy the Law Commission published Issues Paper 6 proposing two categories of remedies for the breach of their proposed two categories of duties. In the first category they suggested to entitle the insured to have damages for foreseeable losses if the insurer acts with bad faith when refusing the valid claim or delaying payment. It is apparent that they meant 'fraudulent intention' by the words 'bad faith'. It is therefore unclear what remedy the insured would obtain if the insurer were negligent in handling a claim, causing significant losses to the insured. It is also unclear whether the insured needs to bear the heavy loss caused by an innocent breach by the insurer in handling claim or delaying payment. Consequently, the problem remains. In order to get rid of the unfairness and unreasonableness the author recommends the following remedies-

#### **Innocent Breach**

*Where the insurer breaches his duty innocently, the author recommends that he will pay the valid claim and half of the foreseeable damage for late payment.*

The reason for requiring the insurer to pay half of the foreseeable damage is to establish a fair balance between the interests of these two parties. In the case of an innocent breach, both parties will have their own arguments. The insured may ask why he should suffer the loss due to the fault, for whatever reason, of the insurer. The insurer may argue that the duty is mutual and as such his innocence is also needs to be considered. Moreover, the innocence of the insured is considered when the remedy is awarded to the insurer against the breach of the

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<sup>1177</sup> The ASIC have discretion to exercise the powers under Subdivision C of Division 4 of Part 7.6 of Corporations Act 2001.

insured's duty. Consequently, requiring the insurer to pay 50% of the damage would establish a fair balance.

#### Negligent Breach

*The insurer will pay the valid claim along with foreseeable damages for late payment where the breach is caused by his negligence.*

In this case the insurer has to pay the total foreseeable damage. This is because the insured would not have been in this situation but for his negligence. Consequently, he has to bear the whole cost.

#### Fraudulent Breach

*The insurer will pay the valid claim, foreseeable damages for late payment as well as interest at judgment rate on the whole amount from the day the claim is made till the day the money is paid.*

The second part of the remedy suggested by the Law Commission is contractual damages for breach of the strict liability to pay within reasonable time. This is the case, even if the insurer has a valid reason for not paying within this period unless it is excluded by an express term. The insurer obviously shall not find it fair and reasonable to pay damages where he has valid grounds to pay later than reasonable time. In such circumstances, it is apparent that he shall choose to exclude his liability by including express terms not to pay damages when he has valid grounds for that late payment. Such an exclusion clause cannot be said unfair in consumer contract under The Unfair Terms in Consumer Contracts Regulations 1999. Consequently, imposition of strict liability will have no effect. Whereas the insured shall have a strong argument to recover the losses incurred due to the late payment of a valid claim regardless the **innocence** of the insurer. *The author therefore recommends allowing the insured to have the valid claim and 50% of the damage.* If the insurer excludes their liability for their **negligence** it would be unfair for the insured not to have the full damage that was caused due to the negligence of the insurer. Consequently, the author recommends that *the insurer shall pay the valid claim and the foreseeable damages.* It would be clearly unfair for the insured if the insurer excludes the liability for his **fraudulent** breach. Consequently, the author recommends that *the insurer should be liable to pay the claim, foreseeable damages*

*as well as interest at judgment rate on the whole amount from the day the claim is made till the day the money is paid.*

The author recommends same remedy for both categories of duties identified by the Law Commission. Where the problem can be solved by one category of duty and one category of remedy, as recommended by the author, then making different categories would cause nothing but unnecessary complication in the legal system.

### **7.3.6 Remedy under Shariah Principles**

Needless to say, current English law is not applicable in Islamic policies due to its unfairness and unjustifiable effect on the insured identified by the courts and academics. The remedy recommended by the Law Commission has limitation in some respects, and is unnecessary and inadequate in others as identified by the author. The author's recommended remedy for English insurance law is argued to be reasonable and justifiable and as such should be Shariah compliant except in the case of the payment of interest. As it is stated above, the Islamic insurers should impose a charge that is equivalent to the judgment rate so as to avoid the effect of the interest. Accordingly, if English insurance law adopts the recommended remedy the application of Islamic policies in English law would be much simpler. However, until the recommended remedies are adopted, Islamic insurers should incorporate adequate terms giving effect to those remedies so as to make their policies Shariah compliant.

### **7.4 Conclusion**

It is well accepted that both the insured and insurer have certain duty during the policy and at the claim stage. The current law has failed to identify the exact nature of that duty as well as to impose appropriate remedies for their breach. The duty of the insured and insurer have already been discussed in Chapter Six, where the author has proposed specific duties for both the second and third stages of the contract. The English law remedy for breach of these duties owed across these two stages are unfair and unreasonable as acknowledged by the courts and academics. Whereas, Shariah principles demand a fair and justifiable duty and remedy. In order to make the remedy fair and reasonable, the Law Commission published issues paper where they proposed remedy for breach of insurer's duty at the claim stage only. However, they proposed to impose damages for foreseeable losses for breach of an insurer's duty to act with 'good faith' and contractual damages for breaching the strict liability of paying valid claim within reasonable time. The strict liability, they suggested, can be excluded by express

terms. It is obvious that in majority cases the insurer shall expressly exclude the strict liability and as such there would not be any remedy for late payment. If the insurer fails to exclude such duty the remedy shall be unfair for them if he rejects the claim upon valid reason but later the court holds that the claim is valid. The remedy for breach of 'good faith' is also unreasonable in that the insured shall not have any remedy where he suffers loss due to the innocent breach of the insurer. Consequently, the remedy proposed by the Law Commission is inadequate.

However, some academics proposed to impose a contractual remedy by considering the duty as implied term, but that is also found to be unjustifiable since it allows the party to breach the duty until it causes damage to the other. In such circumstances the Law Commission's proposal of specific remedy for breach of specific duty is seemed to be the best possible solution to establish justice. The author recommends a specific remedy for the breach of a specific duty. He also recommends a remedy for breach of the insured's duty at the second and third stages of the contract. Since the remedy recommended by the author is argued to be capable of establishing a fair balance they should accommodate Shariah principles apart from the requirement of 'interest'. To get rid of the requirement of interest, Islamic insurers should incorporate certain terms to impose charges in lieu of interest. Consequently application of this remedy in English insurance law shall make it easier for Islamic insurers to take Islamic policies in this country. Until the English law applies the recommended remedy, the insurer of Islamic policies should incorporate adequate terms giving effect to the recommended remedy so as to make the policies Shariah compliant.

## **Appendix**

In Consultation Paper No. 201, published in December 2011, the Law Commission proposed that there should be legislative reform to impose the contractual obligation on the insurer 'to pay valid claims within a reasonable time' and he should be liable 'to pay damages for any foreseeable losses' for breach of that obligation.<sup>1178</sup> However, the insurers should not be allowed to limit or exclude their liability to pay damages for late payment through a term of the contract.<sup>1179</sup> The damages 'for distress and inconvenience or discomfort should be available' to consumer where the insurer agrees to reinstatement.<sup>1180</sup> The Law Commission

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<sup>1178</sup> The Law Commission and the Scottish Law Commission, *Insurance Contract Law: Post Contract Duties and Other Issues* (Consultation Paper No 201, Discussion Paper No 152, 2011) para 5.9

<sup>1179</sup> *ibid* para 5.25.

<sup>1180</sup> *ibid* para 5.54.

asked respondents to consider whether this should be achieved through statutory reform or development of case law.<sup>1181</sup>

The Law Commission proposed to give the statutory effect to the common law remedy of forfeiture, where the insured makes a fraudulent claim.<sup>1182</sup> The definition of ‘the whole claim’ should be left to the courts.<sup>1183</sup> The insured should also lose the subsequent claims ‘even if the claim arises before the insurer discovers the fraud or has taken steps to terminate the contract’.<sup>1184</sup> However, any valid claims made before the fraud took place should remain valid, and not be forfeited.<sup>1185</sup> The Law Commission also proposed that the insurers ‘should be entitled to damages for the reasonable costs actually incurred in investigating the fraudulent claim, where the insurer would otherwise suffer loss as a result of the fraud’.<sup>1186</sup>

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<sup>1181</sup> *ibid* paras 5.53, 5.56.

<sup>1182</sup> *ibid* para 8.8.

<sup>1183</sup> *ibid* para 8.18.

<sup>1184</sup> *ibid* 8.12.

<sup>1185</sup> *ibid* paras 8.2, 8.17.

<sup>1186</sup> *ibid* para 8.3.

## Chapter 8 – General Conclusion

London is claimed to be the hub for Islamic finance.<sup>1187</sup> Several financial products such as the Islamic mortgage, retail banking are in operation for many years. Takaful is a new product which has recently been marketed by Salaam Halal and other companies are also interested to market this product. It is evident that the structures of this product comply with English insurance law. It is currently, assumed that this product will be highly successful in the English market, as it can be marketed to both Muslims and non-Muslims ‘as a “green” product, where the investments made from donations [premiums] are invested ethically’.<sup>1188</sup> Moreover, it has an attractive growth record in the world market, giving strong hopes of its future success in the English market.

However, the application of the contractual part of the product is hindered by the contradiction between the English insurance law and Shariah principles. These contradictions have been analysed in the thesis. Neither the English insurance law nor the Shariah principles are willing to move from its existing position and accept the other. In these circumstances the application of Takaful will be rendered useless as long as the Islamic insurers are bound to follow English law, meaning that their insurance policies will not obey the Shariah principles and cannot be treated as an Islamic product. Consequently, the main purpose of the application of Takaful will be lost.

In order to make its application worthwhile, the thesis has identified several solutions and highlights the simplest and most effective option, which is to modify English insurance law within its own boundaries. The thesis shows that both English insurance law and Shariah principles are heading towards the same direction of establishing a fair balance between the parties, stopping gambling in the guise of insurance and stopping moral hazard. The thesis

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<sup>1187</sup> Michael Ainley and others, ‘Islamic Finance in the UK: Regulation and Challenges’, (2007) FSA 30 <[http://www.fsa.gov.uk/pubs/other/islamic\\_finance.pdf](http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf)> accessed 1st November 2011.

<sup>1188</sup> Reported by Jane Bernstein, ‘Opening the Takaful market’ (22 May 2012) Post online.co.uk <<http://www.postonline.co.uk/post/feature/2179084/takaful-market>> accessed 23 November 2012. See also, Atsuhiko Ayabe, ‘The development of comprehensive takaful products’ in Sohail E. Jaffer (ed), *Regulatory approaches to takaful*, *Islamic Insurance: Trends, Opportunities and the Future of Takaful* (Euromoney Books, London, 2007) 54. Ms Flockhart, senior associate at Norton Rose, commented ‘If insurers can market Takaful in such a way that it appeals to non-Muslim customers in addition to its core Muslim market, then the potential is huge’. Reported by Sam Barrett, ‘Takaful insurance: A future full of potential’ (30 August 2011) Postonline.co.uk <<http://www.postonline.co.uk/post/feature/2105374/takaful-insurance-future-potential>> accessed 26 November 2012. See also Mohammed Amin and Mohammad Kahn ‘Takaful in the EU: Brimming with Potential’ (February 2008) *Mir Takaful in EU* 58



also shows that, in the majority cases, the alleged contradictions are caused due to wrong turns in the English law, towards its target. The thesis has taken the view that if these diversions are diverted back onto the right track of establishing fairness then this contradiction could be substantially reduced (if not fully eliminated).

The Law Commission have taken steps to direct the English insurance law back onto the right track. However, it is always hard to specify which perspective is the correct one, as all observers consider the issues from their own viewpoint and views adapt to meet following new circumstances. In such circumstances, the thesis contributes to the Law Commission's discussion in finding the right track from the author's viewpoint. Consequently, making a contribution to the Law Commission's discussion in developing English insurance law for the purpose of securing the application of Takaful within English law has become a major issue for this thesis. The thesis also makes a contribution in two different ways, Firstly, it analyses possible modifications within English insurance law and consider whether they are consistent with Shariah principles. The thesis has identified that in some cases, the modification of English insurance law will not remove some contradictions since these are caused due to differences in fundamental concepts. In such circumstances the thesis makes the other contribution by proposing to incorporate certain terms in the Takaful contract making it both English law and Shariah compliant.

In order to make the application of the Takaful worthwhile, it is required to research every part of an insurance contract such as, insurable interest, utmost good faith, warranty and conditions, subrogation, third party rights. This thesis contributes to the discussion of the first two parts of the contract, the issue of 'insurable interest' and 'utmost good faith', in consumer insurance policies. Consequently, further research in the remaining areas will be required to complete the project.

The principal part of the thesis started in the third chapter by discussing the requirement of 'insurable interest', without which no one can take a policy under English law. This requirement is imposed to stop gambling in the guise of insurance and moral hazard. All forms of gambling and moral hazard are prohibited in Islam. Consequently, both English insurance law and the Shariah principles intend to achieve similar target. However, the thesis has identified that English insurance law is unable to achieve its target due to the manner in which this requirement is applied, meaning that it also fails to satisfy the Shariah principles.

Hence, the thesis contributes to the Law Commission's discussion of developing this area of law, so that the requirement of insurable interest is applied in such a way as to ensure that it allows English insurance law to achieve its target as well as satisfies the Shariah principles.

In order to find the adequate application of this requirement, the thesis has analysed the arguments of academics, Australian approach, and the Law Commission's provisional proposals. Finding the loopholes in their approaches the thesis suggests a new approach whereby a duty will be imposed on the insurer to take reasonable steps to ensure that the insured has an adequate insurable interest and on the insured to inform the insurer once the policy lapses after the interest ceases to exist. Following these duties, both parties should be able to enjoy a balanced treatment by law and the chance of gambling or moral hazard should also substantially be reduced. Hence the targets of both Shariah principles and English insurance law should be fulfilled. However, both English law and Shariah principles hold different ideologies regarding the policies taken on the insured's own life or on the life of a spouse. Hence, the thesis suggests certain terms to be incorporated in the Takaful contract so as to make it compliant with both English insurance law and Shariah principles.

The discussion of the second part of an insurance contract i.e. utmost good faith has been started in Chapter Four. This chapter has identified that the current duty of the insured to volunteer material information is unfair and unreasonable and that such an unfair and unreasonable duty is not permitted under the Shariah principles. Academics and the courts are also unhappy with the current status of the duty. Parliament has therefore published a Bill, which if enacted would remove the current duty of volunteering information by the insured meaning that the insurer has to ask questions to know the facts. The thesis has identified that such approach will still cause an unfair balance between the interests of these two parties. Hence, it suggests a new approach whereby the insured is required to disclose every fact unless it is immaterial in the eye of a reasonable insured considering the interests of a reasonable insurer. This duty would be fair and reasonable and as such would benefit English insurance law in achieving its aims as well as complying with Shariah principles.

The thesis has also identified that the current duty of an insurer before entering into a contract is also unfair and unreasonable. It has noted that academics and the courts are not concentrating on the modification of this duty. The Bill, therefore, has not made any recommendations in this regard. Consequently, English insurance law will fail to achieve its

target with such unfair duty and also keep itself contradictory with Shariah principles. Hence, the thesis also suggests a new duty for the insurer whereby he is required to disclose every fact unless it is immaterial in the eye of a reasonable insurer considering a reasonable insured's interest in that fact in choosing the right insurance company.

The remedy for breach of the recommended duty before making contract has been discussed in Chapter Five. The thesis has identified that academics, courts and the Law Commission consider the current remedy as being unfair. The Bill suggests new remedies part of which, i.e. the remedy for negligent breach, has been found in this thesis as being fair, whilst the rest remain unfair. The thesis, therefore, suggests new remedies for fraudulent, reckless and innocent breaches of the duty. Due to the fundamental differences between English insurance law and Shariah principles some parts of this recommended remedy would still contradict Shariah principles. Consequently, the thesis suggests a separate remedy for Islamic insurance policies which has to be applied through express terms in the contract. The thesis also recommends remedies for breach of the proposed insurer's duty.

The duty of maintaining utmost good faith during the policy and claim procedure has been discussed in Chapter Six. The chapter has identified that the courts and academics have been unable to figure out the extent of the duty during the lifetime of an insurance policy. Consequently, the duty is not applied adequately. The thesis responds to this problem by defining the duty and recommending to impose the duty on the insured not to do something with the insured object that would effectively concern the insurer about its safety unless a reasonable insured would do had there been no policy or he obtains consent from the insurer. It is submitted that this duty will establish a fair balance benefitting English insurance law in achieving its target as well as will comply with Shariah principles. The current statutory duty of an insured during the claim procedure is also found to be unfair by academics and the courts. In such circumstances, the courts apply the common law duty of not making fraudulent claim. Hence, an excess claim made with negligence will not cause any breach. Consequently, the thesis has found it to be unfair. The thesis, therefore, suggests new duty of dividing the claim procedure into two parts: device and claim. A new duty of handling claim by the insurer has been proposed by the Law Commission. This duty requires the insurer to maintain 'good faith' instead of 'utmost good faith' and imposes strict liability of paying the claim within reasonable time. The thesis has identified that omitting the term 'utmost' will cause unfair results and consequently suggests to retain the term.

The remedy for breach of the duty during the policy and the claim procedure has been discussed in Chapter Seven. The current statutory remedy of avoidance *ab initio* by the innocent party has not been welcomed by the courts or academics. The thesis, therefore suggests remedy for each part of the recommended duty made in Chapter Six.

In summary, this thesis is a guideline for Islamic insurers detailing the exact problems of applying Islamic insurance policies in the English legal system. It has shown that the solution can be achieved without creating a new law or adding to the statute book. In the majority of cases the solution can be achieved by developing English insurance law within its own boundaries. Consequently, the thesis contributes to the development of English insurance law, making a significant contribution to English insurance and Islamic insurance contracts. However, it is obvious that the solutions for the development proposed by the author may be opposed by some academics as he has opposed the solutions given by different academics. Academics who may disagree with these solutions, should still find some assistance from the solution when addressing these problems themselves.

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