

**The Law Commission
Consultation Paper No 201
and
The Scottish Law Commission
Discussion Paper No 152**

**INSURANCE CONTRACT LAW:
POST CONTRACT DUTIES AND OTHER
ISSUES**

A Joint Consultation Paper

This is the second consultation paper in the joint insurance law project

THE LAW COMMISSIONS: HOW WE CONSULT

About the Commissions: The Law Commission and the Scottish Law Commission were set up by section 1 of the Law Commissions Act 1965 for the purpose of promoting the reform of the law.

- The Law Commissioners are: The Rt Hon Lord Justice Munby (*Chairman*), Professor Elizabeth Cooke, Mr David Hertzell, Professor David Ormerod and Frances Patterson QC. The Acting Chief Executive is John Saunders.
- The Scottish Law Commissioners are: The Honourable Lord Drummond Young (*Chairman*), Laura J Dunlop QC, Patrick Layden QC TD, Professor Hector L MacQueen and Dr Andrew J M Steven. The Chief Executive is Malcolm McMillan.

Topic: This Consultation covers four areas of insurance contract law: damages for late payment; insurers' remedies for fraudulent claims; insurable interest; and policies and premiums in marine insurance.

Geographical scope: England and Wales, Scotland.

An impact assessment is available on our websites, and is summarised in Part 21.

Previous engagement: Our first consultation, in 2007, considered Misrepresentation, Non-Disclosure and Breach of Warranty. Subsequently we published five Issues Papers on the subjects covered by this consultation. They are to be found on our websites, together with summaries of the responses we have received (and other insurance project documents).

Duration of the consultation: 20 December 2011 to **20 March 2012**.

How to respond

Send your responses either –

By email to: commercialandcommon@lawcommission.gsi.gov.uk or

By post to: Christina Sparks, Law Commission,
Steel House, 11 Tothill Street, London SW1H 9LJ
Tel: 020 3334 0285 / Fax: 020 3334 0201

If you send your comments by post, it would be helpful if, where possible, you also sent them to us electronically (in any commonly used format).

After the consultation: We plan to publish final recommendations in 2013 and present them to Parliament. It will be for Parliament to decide whether to change the law.

Freedom of information: We will treat all responses as public documents. We may attribute comments and publish a list of respondents' names. If you wish to submit a confidential response, it is important to read our Freedom of Information Statement on the next page.

Availability: You can download this consultation paper and the other documents free of charge from our websites at: <http://www.lawcom.gov.uk> (See A–Z of projects > Insurance Contract Law) and <http://www.scotlawcom.gov.uk> (See News column).

CODE OF PRACTICE ON CONSULTATION

The Law Commission is a signatory to the Government's Code of Practice described below.

THE SEVEN CONSULTATION CRITERIA

Criterion 1: When to consult

Formal consultation should take place at a stage when there is scope to influence the policy outcome.

Criterion 2: Duration of consultation exercise

Consultations should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible.

Criterion 3: Clarity and scope of impact

Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.

Criterion 4: Accessibility of consultation exercises

Consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.

Criterion 5: The burden of consultation

Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.

Criterion 6: Responsiveness of consultation exercises

Consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.

Criterion 7: Capacity to consult

Officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.

CONSULTATION CO-ORDINATOR

The Law Commission's Consultation Co-ordinator is Phil Hodgson. You are invited to send comments to the Consultation Co-ordinator about the extent to which the criteria have been observed and any ways of improving the consultation process.

Contact: Phil Hodgson, Law Commission, Steel House, 11 Tothill Street, London SW1H 9LJ
Email: phil.hodgson@lawcommission.gsi.gov.uk

Full details of the Government's Code of Practice on Consultation are available on the BIS website at <http://www.bis.gov.uk/policies/better-regulation/consultation-guidance>.

Freedom of Information statement

Information provided in response to this consultation, including personal information, may be subject to publication or disclosure in accordance with the access to information regimes (such as the Freedom of Information Act 2000, the Freedom of Information (Scotland) Act 2002 and the Data Protection Act 1998 (DPA)).

If you want information that you provide to be treated as confidential, please explain to us why you regard the information as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Law Commissions.

The Law Commissions will process your personal data in accordance with the DPA and in most circumstances this will mean that your personal data will not be disclosed to third parties.

THE LAW COMMISSION

THE SCOTTISH LAW COMMISSION

**INSURANCE CONTRACT LAW: POST CONTRACT
DUTIES AND OTHER ISSUES**

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HOW TO RESPOND

- 1.1 This Consultation Paper is part of a wider review of insurance contract law, carried out by the Law Commission and Scottish Law Commission. It covers four topics:
- (1) Damages for late payment (Chapter 1);
 - (2) Insurers' remedies for fraudulent claims (Chapter 2);
 - (3) Insurable interest (Chapter 3);
 - (4) Policies and premiums in marine insurance (Chapter 4).
- 1.2 A summary of the paper is available on our websites at <http://www.lawcom.gov.uk> and <http://www.scotlawcom.gov.uk>. We are also publishing on our websites a separate impact assessment of our proposals.
- 1.3 This paper follows a previous consultation paper in 2007 on Misrepresentation, Non-Disclosure and Breach of Warranty. We have also published five Issues Papers on the subjects covered by this consultation. These, together with summaries of the responses we have received (and other insurance project documents), are available on our websites.

HOW TO RESPOND

- 1.4 We are seeking responses by **20 March 2012**. Respondents may wish to respond on one or more subjects, or to the full paper. We have created a response form on each of the four subjects, to assist consultees who wish to respond in this way. These can be downloaded from our websites at the addresses below. In the alternative, consultees may submit their response using their own format.

Please send responses by 20 March 2012 either –

By email to: commercialandcommon@lawcommission.gsi.gov.uk or

By post to: Christina Sparks, Law Commission, Steel House, 11 Tothill Street,
London, SW1H 9LJ

Tel: 020 3334 0285 / Fax: 020 3334 0201

Responses forms available at: <http://www.lawcom.gov.uk> (A-Z of projects >Insurance Contract Law and <http://www.scotlawcom.gov.uk> (See News column)

TABLE OF ABBREVIATIONS

The 1906 Act	Marine Insurance Act 1906
ABI	Association of British Insurers
BIBA	British Insurance Brokers' Association
BILA	British Insurance Law Association
CASS	Client Assets Sourcebook (part of the Financial Services Authority rules)
CIF	Cost Insurance Freight – a form of sale of goods contract in which the seller bears the costs of shipping the goods.
CLLS	City of London Law Society
FOIL	Forum of Insurance Lawyers
FOS	Financial Ombudsman Service
FSA	Financial Services Authority
FSMA	Financial Services and Markets Act 2000
ICOBS	Insurance Conduct of Business Sourcebook (part of the Financial Services Authority rules)
IIB	Institute of Insurance Brokers
IUA	International Underwriting Association
LMA	Lloyd's Markets Association
MRC	Market Reform Contract
TEPS	Traded Endowment Policies
TOBA	Terms of Business Agreement
UTCCR	Unfair Terms in Consumer Contracts Regulations 1999

All websites referenced in this document were valid as of 24 November 2011

PART 1

INTRODUCTION

- 1.1 The English and Scottish Law Commissions are undertaking a joint review of insurance contract law. Our aims are to ensure that the law balances the interests of policyholders and insurers; reflects the needs of modern insurance practice; and allows both parties to know their rights and obligations.

THE HISTORY OF THE PROJECT

The scoping study

- 1.2 The review has been carried out in full consultation with stakeholders, including insurers, brokers, risk managers and consumer groups. In January 2006 we published a scoping study to consult on the issues which needed to be addressed and were in need of reform.¹ We explained that we would be considering the law of misrepresentation, non-disclosure and breach of warranty. We then asked whether there were other areas of insurance law we should review.
- 1.3 We received 118 responses to our 2006 scoping study, from a wide variety of organisations and individuals. The responses showed strong support for looking at post-contract good faith, particularly at how it affected fraudulent claims and damages for late payment. We were also asked to look at the law of insurable interest and at two provisions of the Marine Insurance Act 1906 which were thought to be out-of-date, namely section 22 (on the need for a formal policy) and section 53 (broker's liability for premium).²
- 1.4 The Commissions' first consultation in 2007 covered pre-contract issues in consumer and business insurance. The size of the project led the Commissions to design a phased programme. This is the second consultation and covers the post-contract issues we were asked to review. In 2012 we will be publishing a third consultation on business insurance and warranties.

Issues papers

- 1.5 For each area under review, we published an Issues Paper, setting out tentative conclusions and seeking views. The paper is based on the following Issues Papers:
- (1) Issues Paper 4: Insurable Interest, January 2008.
 - (2) Issues Paper 6: Damages for Late Payment and the Insurer's Duty of Good Faith, March 2010.

¹ Insurance Contract Law: A Joint Scoping Paper, the Law Commission and the Scottish Law Commission (January 2006).

² For a full account of the responses we received, see Analysis of Responses and Decisions on Scope, August 2006.
http://www.justice.gov.uk/lawcommission/docs/ICL_Scoping_Responses_and_Analysis.pdf

- (3) Issues Paper 7: The Insured's Post-Contract Duty of Good Faith, July 2010.
 - (4) Issues Paper 8: The Broker's Liability for Premiums, July 2010.
 - (5) Issues Paper 9: The Requirement for a Formal Marine Policy, October 2010.
- 1.6 Following the Issues Papers, we held meetings and seminars and received written responses.³ This allowed us to develop (and in some cases change) our thinking. This Consultation Paper is based on the views we have received. Nevertheless, we thought it important to provide an opportunity for those who responded to the Issues Papers to comment on the full set of proposals. We also hope to hear from a wider range of stakeholders.
- 1.7 We will take these views into account in developing our final proposals and in drafting legislation, which we plan to publish in 2013.

Other strands to the review

- 1.8 In 2007 we published our Consultation Paper on Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured. The responses showed strong support for reforming the law of misrepresentation and non-disclosure as it affected consumer insurance. Therefore, in 2009 we published a final Report on Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation, with a draft Bill.⁴ At the time of writing, the Consumer Insurance (Disclosure and Representations) Bill is being considered by Parliament, through the special procedure for uncontroversial Law Commission Bills.⁵
- 1.9 There was less agreement on how the law of non-disclosure, misrepresentation and warranties should be reformed for large, medium and small businesses. In Issues Paper 5, we considered whether there should be a special regime for unsophisticated micro-businesses, though this proved a particularly difficult category to define. We are continuing informal discussions in this area, and plan to publish a third Consultation Paper in 2012, which will cover pre-contract non-disclosure and representations in business insurance and the law of warranties in business and consumer insurance.
- 1.10 Following consultation on this paper and the next, we plan to publish a final report and draft Bill, completing our insurance law project by the end of 2013.

³ Summaries of the responses we received to Issues Papers 6, 7, 8 and 9 are available on our websites.

⁴ Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation (2009) Law Com No 319; Scot Law Com No 219.

⁵ In July 2010, the House of Lords Procedure Committee issued its report on the trial procedure, recommending that the procedure should be made permanent; and that it should specifically be extended to reports of the Scottish Law Commission, as well as the Law Commission. The Procedure Committee's report was considered and approved by the House on 7 October 2010 (see <http://www.publications.parliament.uk/pa/ld201011/ldselect/ldprohse/30/30.pdf> and <http://www.publications.parliament.uk/pa/ld201011/ldhansrd/text/101007-0001.htm#10100714000813>).

EUROPEAN DEVELOPMENTS

1.11 In a world of global finance, the UK increasingly has to justify differences in commercial law between the UK and its European partners. The European Commission has mentioned insurance contract law as one particular area where alternative common legal rules should be considered.⁶ In September 2011, the EU Justice Commissioner, Viviane Reding, stated that the European Commission:

wants to start a dialogue with the insurance sector about the possible added value of an optional European Insurance Contract Law, on which work could start in 2012.⁷

1.12 This follows the work conducted by the Restatement of European Insurance Contract Law Project Group (“the Innsbruck Group”).⁸ In 2009 the Group published Principles of European Insurance Contract Law, which were submitted to the European Commission as a Draft Common Frame of Reference. The Project Group comments that it has drafted the Principles as a model for an Optional Instrument of European Insurance Contract Law.⁹

1.13 UK insurance law is based on different principles from civil law systems. It is unlikely that the European Union would seek to impose a civil law system on the UK. On the other hand, negotiations over an optional system would expose areas where UK insurance law is so confused or outdated that it is difficult to justify to an international audience. We therefore think that it would be timely to reform those areas of insurance law that are considered to be particularly problematic.

THE CONTENTS OF THIS PAPER

1.14 The paper is divided into four main self-contained chapters. Consultees are asked to consider and comment on whichever chapters are relevant to them. Each chapter includes a short account of the current law, but more detail is available in the Issues Papers, which are to be found on our websites.¹⁰ We have also published full summaries of the responses to Issues Papers 6, 7, 8 and 9. Again, these are available on our websites.

1.15 The four chapters are:

- (1) Chapter 1: Damages for late payment.
- (2) Chapter 2: Insurers’ remedies for fraudulent claims.
- (3) Chapter 3: Insurable interest.

⁶ Communication from the Commission to the European Parliament and the Council, “An Area of Freedom, Security and Justice serving the Citizen” (10 June 2009) (COM (2009) 262 Final), at para 3.4.2.

⁷ See memo 11/625 at <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/624&format=HTML&aged=0&language=EN&guiLanguage=en>.

⁸ See <http://www.restatement.info>.

⁹ J Basedow and others, *Principles of European Insurance Contract Law* (2009).

¹⁰ www.lawcom.gov.uk; www.scotlawcom.gov.uk.

(4) Chapter 4: Policies and premiums in marine insurance.

- 1.16 The final chapter, Chapter 5, discusses the impact of our proposals and lists our proposals and questions.

Chapter 1: Damages for late payment

- 1.17 In Issues Paper 6, we asked whether an insurer should be liable for a policyholder's loss suffered as a result of a late payment or non-payment of an insurance claim.¹¹ The current position under English law is that an insured is not entitled to damages for any loss suffered through delay in receiving money for a valid claim.
- 1.18 The case of *Sprung v Royal Insurance (UK) Ltd*¹² illustrates the problems. When Mr Sprung suffered damage to his factory, the insurers failed to pay his claim for four years, by which time he had been forced out of business. The judge found that, as a result of the insurer's delayed payment, he had suffered further losses of £75,000. The Court of Appeal held, with "undisguised reluctance", that the insurers were not liable for losses of this type.
- 1.19 This differs from the law in Scotland, where a late payment of a claim is considered to be a breach of an implied term giving rise to damages under ordinary contract law principles. The English position appears anomalous and is increasingly hard to justify. The responses we received to Issues Paper 6 showed strong support for reform and we set out proposals in this area.

Chapter 2: Insurers' remedies for fraudulent claims

- 1.20 Fraud is a serious and expensive problem. It is important that the law sets out clear sanctions to deter policyholders from acting fraudulently. Unfortunately, the law in this area is convoluted and confused. There is a tension between the common law rule that a fraudster forfeits the claim, and the statutory rule in section 17 of the Marine Insurance Act 1906 that the policy is avoided. It is not clear whether following a fraud the insurer must pay a subsequent claim. Furthermore, it is unlikely that an insurer can claim damages for the costs of investigating fraud.

¹¹ Insurance Contract Law Issues Paper 6: Damages for Late Payment and the Insurer's Duty of Good Faith (March 2010).

¹² *Sprung v Royal Insurance (UK) Ltd* [1999] 1 Lloyd's Rep IR 111.

1.21 We discussed the issues surrounding fraudulent claims in Issues Paper 7.¹³ In response, the great majority of consultees asked for the law to be clarified. We have concentrated on practical remedies which provide a clear deterrent. We propose that fraud should not avoid the contract from the start. Avoidance is a difficult remedy, which treats the contract as if it never existed: not only may the insurer refuse all claims, but it may also recoup any past claims, including valid ones. We think that it is not the appropriate remedy. Instead, the fraudster should forfeit the whole claim, and all subsequent claims. Furthermore, we propose that in some circumstances the insurer should be entitled to claim damages from a fraudulent insured for the costs of investigating the fraud.

1.22 Our review is limited to insurance contract law. Thus this Consultation Paper does not consider fraud by third party claimants. Nor does it consider the criminal law.

Chapter 3: Insurable interest

1.23 For a contract of insurance to be valid, the policyholder must possess an “insurable interest”. The underlying principle is simple. Insurance differs from gambling because it is used to compensate for loss. Thus for insurance on goods or land, the policyholder must stand to gain a benefit from the preservation of the subject matter of the insurance or to suffer a disadvantage should it be lost. Similarly for life insurance, the policyholder must stand to suffer a loss on the death.

1.24 We discussed the issues surrounding insurable interest in Issues Paper 4.¹⁴ Responses revealed strong support for retaining the principle of insurable interest. It was thought to guard against moral hazard, protect insurers from invalid claims and provide a dividing line between gambling and insurance.

1.25 The law on insurable interest is not as straightforward as it should be. It has been described as “a confusing and illogical mess”.¹⁵ One reason is that it is a complex mix of common law authorities and archaic statutes, including the Life Assurance Act 1774 and the Marine Insurance Act 1788. We propose to replace the current bewildering array of statutes with a clear restatement of the principles by repealing certain Acts, culminating in a Bill before Parliament in due course.

¹³ Insurance Contract Law Issues Paper 7: The Insured’s Post-Contract Duty of Good Faith (July 2010).

¹⁴ Insurance Contract Law Issues Paper 4: Insurable Interest (January 2008).

¹⁵ R Merkin, *Reforming insurance law: is there a case for reverse transportation?* Report for the English and Scottish Law Commissions on the Australian experience of insurance law reform (2007).

- 1.26 For life insurance, insurable interest has been interpreted in a restrictive way. A person may insure his or her own life, or that of a spouse or civil partner, but generally may not insure the life of a cohabitant, parent or child. It is possible to insure the life of another where the policyholder would suffer financial loss on the other's death. This, however, requires "a pecuniary interest recognised by law" rather than just a reasonable expectation of loss. Thus the courts have held that a father's expectation that his son would care for him or maintain him was not sufficient to constitute an insurable interest in the son's life.¹⁶
- 1.27 We propose to widen the categories of those who may insure the life of another, to include those who have a real probability of incurring an economic loss on the other's death. We ask whether parents should be entitled to insure the lives of children under 18, perhaps for a limited amount, and whether a cohabitant should have an insurable interest in the life of another where they have lived in the same household as a spouse or civil partner.

Chapter 4: Policies and premiums in marine insurance

- 1.28 This chapter applies only to marine insurance. In 2006, we were asked to look at two provisions of the Marine Insurance Act 1906 which appeared outdated and problematic: sections 22 and 53. Chapter 4 reflects our work in this area.
- 1.29 In Issues Paper 9 we considered section 22, which requires a contract of marine insurance to be "embodied in a marine policy". This dates from 1795, when stamp duty was imposed on marine insurance. The tax was not on the contract itself, but on the formal document, which had to be stamped. Thus the original purpose of section 22 was to prevent tax evasion. Although stamp duty on marine insurance policies was abolished in 1970, the requirement for a marine policy remains.
- 1.30 The responses to Issues Paper 9 showed that practice has changed. Section 22 is widely ignored and there was general support for repealing it. The UK is one of the world's leading insurance law jurisdictions, and outdated and unused provisions undermine the respect with which the law of the UK is held.
- 1.31 As we considered the issue, it became clear that section 22 is not an isolated provision. Removing the requirement for a marine policy would have implications for around a dozen provisions of the Marine Insurance Act 1906. We discuss each in turn to ensure that there are no unconsidered implications of the changes.
- 1.32 Section 53 of the Marine Insurance Act was discussed in Issues Paper 8. Section 53(1) makes a marine broker liable to pay premiums to the insurer. It is a complex provision. It appears to reflect the common law position, in which the insured was *not* liable to pay premiums to the insurer. This could have surprising consequences if a marine broker were to become insolvent. We think the position needs to be clarified, to state that policyholders are liable to pay premiums to the insurer.

¹⁶ *Halford v Kymer* (1830) 10 B&C 724.

- 1.33 We provisionally propose default rules which reflect current market practice. We suggest that, in the marine market, the default rule should be that the broker is jointly responsible for the premiums, but that it should be simple for the parties to contract out of this provision.
- 1.34 Under section 53(2), the broker has a lien over the marine policy, which raises issues discussed in both Issues Papers 8 and 9. We consider the problems raised by this section and propose a statutory re-statement.

OVER-ARCHING ISSUES

The problems of section 17

- 1.35 Two sections of the paper (on damages for late payment and fraudulent claims) consider the effects of section 17 of the Marine Insurance Act 1906. The section states that an insurance contract:
- is a contract based upon the utmost good faith, and, if the utmost good faith be not observed by either party, the contract may be avoided by the other party.
- 1.36 We considered this section in our first Consultation Paper, in relation to the insured's duty to disclose material circumstances before the contract is made. It is not, however, confined to pre-contract issues. It also applies after the contract has been formed, though the courts have struggled to make sense of it in a post-contract context.¹⁷
- 1.37 There is much to be said for the general principle that both parties to an insurance contract should act in good faith. Insurance gives rise to moral hazards. There is a danger that unscrupulous policyholders might inflate or fabricate claims, while unscrupulous insurers might delay consideration of claims or find excuses not to pay. As the title of this Consultation Paper suggests, both the chapters on late payment and on fraudulent claims raise issues about the duty to act in good faith after a contract has been made.
- 1.38 The problem with section 17 lies in the remedy. Section 17 mentions only one remedy – avoidance. This is said to be avoidance “*ab initio*”, or “from the beginning”. It means that the contract is treated as if it never existed so that the insurer is not liable for any claims which may have arisen under it.
- 1.39 There are several problems with avoidance. As we discuss in Part 3, it is a wholly one-sided remedy. Although the duty of good faith applies to both parties, only the insurer is likely to seek avoidance. Most policyholders, by contrast, wish to have their claims paid. Secondly, the remedy may be overly harsh. This is a particular problem where the contract has been operated successfully for some time. As we discuss in Part 6, the courts are reluctant to undo valid payments made under a valid contract as a result of subsequent acts. Avoidance does not appear an appropriate remedy for a fraudulent claim.

¹⁷ *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd (The Star Sea)* [2001] UKHL 1, [2003] 1 AC 469.

- 1.40 We will return to the issue of avoidance in our third consultation paper, when we consider whether avoidance should always be the insurer's remedy for the policyholder's non-disclosure. In that consultation paper we will consider reforms to section 17. As we discuss in Parts 5 and 7, we think good faith is best thought of as a shield rather than a sword. We are minded to keep the duty of good faith as a general interpretative principle, which can be used to prevent either party from using their rights in bad faith, but it would not, in itself, give rise to any specific cause of action. Instead, the remedies for fraud, non-disclosure and misrepresentation should be set out specifically in the legislation.

Contracting out

- 1.41 As we explain in this Consultation Paper, we think that commercial insurance contracts should be based on freedom of contract. Most of the rules we set out are default rules, which can be changed by express agreement between the parties.
- 1.42 That said, we do not think that express terms should enable either side to act in bad faith. Thus we propose to maintain the rule that a policyholder may not contract out of all liability for fraud. Similarly, in Part 5 we propose that an insurer should be entitled to contract out of its liability to pay damages for late payment, but not to the extent that this would allow the insurer to act in bad faith.
- 1.43 In respect of fraud, we set out default remedies. Commercial parties could agree to extend these remedies, but only if the term is in clear and unambiguous language. If the insurer proposes such a term, it would need to bring it specifically to the attention of the insured.
- 1.44 By contrast, for consumer insurance, several of the proposals we make are mandatory. We propose that the provisions on damages for late payment and remedies for fraudulent claims should not be able to be excluded by contract. This mirrors the position in the Consumer Insurance (Disclosure and Representations) Bill currently before Parliament. The Bill provides that a term is of no effect if it purports to put the consumer in a worse position than that provided for by the Bill.

SECTION 83 OF THE FIRES PREVENTION (METROPOLIS) ACT 1774

- 1.45 In response to the scoping study we were asked to review section 83 of the Fires Prevention (Metropolis) Act 1774, which deals with cases where buildings are damaged by fire. The Act does not extend to Scotland. Broadly, it gives "interested persons" the right to demand that insurance money is used to reinstate the property, rather than being paid to the policyholder.
- 1.46 Originally this was seen as a way of preventing arson and fraud. Now the section is occasionally used to solve problems where the person who has suffered loss from the fire is not the insured. The Bar Council mentioned cases where, for example, landlords insured property but were looking at opportunities to redevelop. They suggested that landlords had been known to "drag their feet" in pursuing insurers following a fire, in the hope that the tenants would move out or lose interest in resuming occupation. The section could be used to allow the tenant to require the insurer to reinstate the property.

- 1.47 In March 2009 we published a short paper on the issue which discussed the cases on section 83. We asked whether section 83 should be repealed, reformed or retained.¹⁸ Of the 13 respondents, eight felt that section 83 should be kept in its current form, with no change.¹⁹ People thought that, despite its age and archaic wording, it has the potential to do justice in a small number of cases. As the City of London Corporation put it:

It appears that the section has the potential to offer “fairness” and that to simply repeal it would be to risk losing something of potential (if very infrequent) value.

- 1.48 A few people suggested updating the language of the section, but the reforms suggested were minor ones. Given how rarely the section is used, we do not think they are sufficiently important to justify reform.
- 1.49 The responses indicated strong support for retaining section 83. We do not propose changes to section 83 of the Fires Prevention (Metropolis) Act 1774, and do not discuss it further in this Consultation Paper. We are grateful to all those who responded to our paper.

A NOTE ON TERMINOLOGY

- 1.50 In this Consultation Paper we describe the parties to an insurance contract as “insurer” and “insured”, or as “insurer” and “policyholder”. Both terms are used synonymously. Generally, we prefer the term policyholder, as it is less likely to produce confusion over which party is which. It is not an appropriate term however, when we discuss the need for a formal marine policy. In Chapter 4 we describe how an insured does not necessarily need to hold a formal policy. In other chapters of the paper, we use the term “policyholder” colloquially, and do not intend to confine it to those who possess a formal policy.

THANKS

- 1.51 Our pre-consultation discussions with stakeholders and the responses we have received to our Issues Papers have been integral to shaping our approach to this Consultation Paper. We would like to thank all those who took the time and trouble to meet and discuss issues with us and to respond to our proposals. A list of those who responded to each of the Issues Paper is set out in Appendix 1.

¹⁸ Insurance Contract Law Short Paper: Section 83 of the Fires Prevention (Metropolis) Act 1774 (March 2009).

¹⁹ Section 83: Summary of Responses (available on Law Commission website).

CHAPTER 1

DAMAGES FOR LATE PAYMENT

PART 2

DAMAGES FOR LATE PAYMENT: THE CURRENT LAW

INTRODUCTION

- 2.1 In this Chapter we consider whether an insured who has suffered loss should be entitled to damages where the insurer has refused to pay a valid insurance claim, or has only paid after considerable delay. As we will see, the current position of English law is that such damages are not available.¹
- 2.2 This is a unique rule. In this area, the law of England and Wales differs from that of Scotland and other major common law jurisdictions. Under Scots law, late payment of a valid claim is considered to be a breach of an implied contract term giving rise to damages subject to ordinary contract law principles.² Furthermore, the prohibition against damages for late payment does not apply to non-indemnity insurance such as life insurance,³ or where the insurer has agreed to reinstate the property.⁴ Additionally, the Financial Ombudsman Service (FOS) applies different rules to consumer disputes.⁵
- 2.3 In Issues Paper 6 we invited views on this rule.⁶ Most consultees agreed that the rule was increasingly anomalous and that there was a need for reform.⁷ We have developed our proposals for reform in the light of the responses we received.
- 2.4 We discuss damages for late payment in four parts:
- (1) In this Part we set out the current law governing damages for late payment, and highlight the underlying principle in this area as anomalous.
 - (2) Next, in Part 3 we consider three alternative routes to redress. We discuss the duty of good faith, claims for breaches of Financial Services Authority (FSA) rules and the approach of the FOS.
 - (3) In Part 4 we provide an overview of the feedback we received on Issues Paper 6 and set out the case for reform.
 - (4) In Part 5 we explain our proposals for reform.

¹ *Sprung v Royal Insurance (UK) Ltd* [1999] 1 Lloyd's Rep IR 111.

² *Strachan v The Scottish Boatowners' Mutual Insurance Association* 2010 SC 367.

³ See para 2.59 below.

⁴ See para 2.60 below.

⁵ See para 2.79 below.

⁶ Insurance Contract Law Issues Paper 6: Damages for Late Payment and the Insurer's Duty of Good Faith (March 2010).

⁷ For more, see Insurance Contract Law, Summary of Responses to Issues Paper 6: Damages for Late Payment and the Insurer's Duty of Good Faith (November 2010).

2.5 In this Part, we describe the ordinary principles which apply to damages for breach of contract in general contract law. We contrast this with the special rule for insurance claims, set out in *Sprung v Royal Insurance (UK) Ltd*.⁸ There, it was held that damages are not available where an insurer delays payment or wrongly refuses to pay a claim. We look to the historic legal fiction which underlies the rule, and examine the way it has been applied in case law following *Sprung*. We then consider the Scottish approach, which has not followed English law. Finally, we consider when damages for distress and inconvenience may be available for consumers, and the implications of *Sprung* for the rules on limitation periods.

DAMAGES IN GENERAL CONTRACT LAW: HADLEY V BAXENDALE

2.6 Under English and Scots law, where one party breaches a contract the innocent party may claim damages for the loss suffered. The claimant must prove that actual, financial loss was incurred; establish that the loss was foreseeable at the time the contract was made; and show that reasonable steps had been taken to mitigate that loss. The level of damages may be limited by express provisions of the contract.

2.7 These principles were set out in 1854 in the case of *Hadley v Baxendale*.⁹ Mr Hadley was the co-proprietor of a mill in Gloucester, which arranged for a firm of carriers to take their broken crankshaft to Greenwich for repair on a contracted date. The carriers were delayed in breach of contract. However, the carriers had not realised that the mill could not operate without the new crankshaft. Thus, when the manufacturers in Greenwich delayed making a replacement shaft, the millers lost business. They claimed for loss of profit.

2.8 The court set out that losses may be recoverable if they may “reasonably be supposed to have been in the contemplation of both parties at the time they made the contract”. These losses are of two kinds:

- (1) those which may fairly and reasonably be considered as arising naturally, “according to the usual course of things”; or
- (2) those arising from any special circumstances which were communicated at the time the contract was made.

2.9 Firstly, the court held that the loss of profits did not arise naturally from the delay. Secondly, the fact that the mill could not operate without the shaft was a special circumstance, which had not been communicated to the carriers. Therefore, under both limbs, Mr Hadley’s claim was rejected.

⁸ [1999] 1 Lloyd’s Rep IR 111.

⁹ (1854) 156 ER 145. The case is also regarded as authoritative in Scotland.

Subsequent cases

- 2.10 The test under *Hadley v Baxendale* has been considered many times and applied cautiously. Under the first branch of the test, a loss is said to arise naturally only if it had been a “serious possibility” or a “not unlikely” result at the time when the contract was entered into.¹⁰
- 2.11 In 2008, *The Achilleas*¹¹ stressed that the rule on foreseeable loss should be applied with a view to commercial reality and the context in which the contract was made. The case was about chartering a ship: the charterers had returned the ship late. As a result, the owners were unable to meet the terms of a follow-on charter and could only retain the second charter at a discounted rate. The owners claimed the difference between the second charter’s higher, original rate and the reduced rate over the whole period of the second charter. The charterers said they were only liable to compensate the owners for the overrun period.
- 2.12 Lord Hoffmann said that the rule in *Hadley v Baxendale* applied in the great majority of cases. It was, however, important to interpret the contract as a whole, within its commercial setting, and look at what the parties may reasonably have expected. He asked if the rule that makes foreseeable losses available can be rebutted if:

the context, surrounding circumstances or general understanding in the relevant market shows that a party would not reasonably have been regarded as assuming responsibility for such losses.¹²

The House of Lords decided that the context should be taken into account. They heard evidence that it was general commercial practice that damages were limited to losses during the overrun period. They held that this understanding should be respected.

- 2.13 Additionally, the amount recoverable by a claimant is limited by the claimant’s duty to mitigate the loss. The law expects the victim of a breach of contract to act as if there is no one from whom to claim compensation. This means that the victim must take all reasonable steps to reduce the scale of the loss.

THE UNENVIABLE POSITION OF MR SPRUNG

- 2.14 The English courts have held that a contract of indemnity insurance is an exception to the usual rules of contract law. This is based on a legal fiction that an insurer’s primary obligation is to “hold the insured harmless”.¹³ As we will see, this has led to strange results.

¹⁰ See, for example, *Victoria Laundry (Windsor) Ltd v Newman Industries Ltd* [1949] 2 KB 528, *Koufos v C Czarnikow (The Heron II)* [1969] 1 AC 350. In particular, it was noted in *The Heron II* that the test is more restricted than “reasonably foreseeable” loss in tort law, by Lord Reid at p 385.

¹¹ *Transfield Shipping Inc of Panama v Mercator Shipping Inc of Monrovia (The Achilleas)* [2008] UKHL 48; [2009] 1 AC 61.

¹² Above, at [9] to [12].

¹³ See paras 2.19 to 2.22 below

- 2.15 In *Sprung v Royal Insurance (UK) Ltd*,¹⁴ Mr Sprung was a small businessman who owned a family business that processed animal waste. He bought insurance to protect his factory against theft and “sudden and unforeseen damage”. When vandals broke into his premises, both his factory and his plant were badly damaged. Mr Sprung submitted a claim to his insurer under the policies, and his claim was rejected.
- 2.16 Mr Sprung’s insurers contended that no theft had occurred and that the policies did not provide cover for “wilful damage”. In difficult economic conditions, Mr Sprung found himself in an unenviable position. He lacked the finance to carry out repairs, and he was unable to raise a loan. Six months later, Mr Sprung was out of business.
- 2.17 Mr Sprung started proceedings against his insurers. Four years later, the insurers abandoned their defence, and Mr Sprung was awarded an indemnity for his lost plant and machinery, plus simple interest and costs. The judge found that the claim should have been paid four years earlier. As a result of the insurer’s failure, Mr Sprung suffered a further loss of £75,000.
- 2.18 Mr Sprung was not, however, entitled to claim this further loss. The Court of Appeal, with “undisguised reluctance”,¹⁵ considered itself bound by the principle that there could be no award of damages for late payment. Lord Justice Beldam called for reform of the law:

There will be many who share Mr Sprung’s view that in cases such as this such an award [Mr Sprung’s indemnity plus simple interest] is inadequate to compensate him or any other assured who may have to abandon his business as a result of insurers’ failure to pay, and that early consideration should be given to reform of the law in similar cases.¹⁶

The “hold harmless” principle

- 2.19 The reasoning in *Sprung* arises because of the historic rule that an insurer’s fundamental obligation is to “hold the insured harmless”. Under English law, an insurance contract is treated as analogous to a contract with a security firm, in which the security firm undertakes to prevent a break-in. The insurer’s obligation is to prevent loss occurring rather than to compensate for loss.
- 2.20 In 1990 this was confirmed in the joint cases of *The Fanti* and *The Padre Island*.¹⁷ Lord Goff put it in the following terms:

¹⁴ [1999] 1 Lloyd’s Rep IR 111.

¹⁵ Above, at 118.

¹⁶ Above, at 119.

¹⁷ *Firma C-Trade SA v Newcastle Protection and Indemnity Association (London) Ltd (The Fanti)*; *Socony Mobil Oil Inc v West of England Shipowners Mutual Insurance Association (The Padre Island)* [1991] 2 AC 1.

A promise of indemnity is simply a promise to hold the indemnified person harmless against a specified loss or expense. On this basis, no debt can arise before the loss is suffered or the expense incurred; however, once the loss is suffered or the expense incurred, the indemnifier is in breach of contract for having failed to hold the indemnified person harmless against the relevant loss or expense.¹⁸

2.21 In other words, an insurer's fundamental obligation is not to pay claims but to prevent the loss occurring in the first place. This is a surprising view. As the judge put it in *Transthene v Royal Insurance*, property insurers may be surprised to discover that, on this argument:

they are, collectively, in breach of contract hundreds or thousands of times every day, whenever a fire, a flood, a road accident or other such event occurs.¹⁹

2.22 This analysis means that the law regards insurance payments not as debts due under the contract, but as damages for breach of contract. As we shall see, the courts have held that claimants are not entitled to damages for the non-payment of damages. However, the "hold harmless" analysis has not been applied to life insurance²⁰ or to policies for reinstatement.²¹

The Italia Express

2.23 In 1992, the Commercial Court considered what effect the "hold harmless" doctrine had on a claim for damages for late payment of an insurance claim.²² The owners had insured a ship, *The Italia Express*, against war risks for \$4 million. The ship was sunk by explosives while it was undergoing repairs near Piraeus harbour. The insurers suspected the owners of sinking the ship deliberately, and pursued these allegations for three and a half years. The insurers' case depended on surreptitious tape recordings. When those tape recordings were declared inadmissible, the allegations were withdrawn and the \$4 million was paid.

2.24 The owners claimed for damages caused by the delay in payment. These included the loss of income which would have been earned by a replacement vessel; the increase in the capital value of a replacement vessel; and distress and inconvenience caused by the delay.

¹⁸ Above, at 35 to 36.

¹⁹ *Transthene Packaging Co Ltd v Royal Insurance (UK) Ltd* [1996] Lloyds' Rep IR 32, at 40.

²⁰ *Blackley v National Mutual Life Association Ltd (No 2)* [1973] 1 NZLR 668, in which a claim was treated as a contract debt and the usual rules of contract law applied.

²¹ For example, in *Arbory Group v West Craven Insurance Services* [2007] Lloyd's Rep IR 491, discussed below in 2.55.

²² *Apostolos Konstantine Ventouris v Trevor Rex Mountain (The Italia Express (No 3))* [1992] 2 Lloyd's Rep 281.

2.25 This raised issues about the nature of the insurers' duties. The claimant argued that the insurers' obligation was to pay the claim within a reasonable time. As the insurers had failed to do so, they were liable for damages for breach of this obligation. By contrast, the insurers invoked the "hold harmless" principle, arguing that their primary obligation was to prevent the loss from occurring in the first place, and that the remedy for this breach was to pay liquidated damages of \$4 million as agreed under the contract. The insurers had done this, and no further damages were payable. Mr Justice Hirst agreed with the insurers:

Once the loss is suffered or the expense incurred, the indemnifier is in breach of contract for having failed to hold the indemnified person harmless against the relevant loss or expense; this phraseology is entirely appropriate to cover both the *loss* against which the insured is indemnified under property insurance, and the *expense* against which he is indemnified under liability insurance.²³

2.26 Mr Justice Hirst then applied the rule in *The Lips*, which said that "there is no such thing as a cause of action in damages for late payment of damages".²⁴ Therefore the claim for damages for late payment must fail.

No damages for failing to pay damages: *The Lips*

2.27 *The Lips*²⁵ was another dispute between the owner and the charterers of a ship. The charterers had agreed to unload cargo within a certain number of lay-days. If the charterers took longer, they agreed to pay a defined sum in damages (known as "demurrage"). The contract specified that the payment of US \$6,000 a day was to be paid in sterling, set at the exchange rate for the date of the bill of lading.

2.28 The ship took too long to unload, which led to a dispute about how much demurrage should be paid. By the time the issue was eventually resolved, sterling had depreciated. An umpire awarded around £10,200 for outstanding demurrage, plus around £5,500 for damages for the late payment of this outstanding sum, due to the depreciation in sterling.

2.29 The House of Lords disallowed the additional damages for delay in paying damages. They held that demurrage was a form of agreed liquidated damages, and no additional damages were available for a failure to pay damages. As Lord Brandon put it:

Most, if not all, voyage charters contain a demurrage clause, which prescribes a daily rate at which the damages for such detention are to be quantified. The effect of such a clause is to liquidate the damages payable.²⁶

²³ Above, at 292.

²⁴ *The President of India v Lips Maritime Corporation (The Lips)* [1988] AC 395, by Lord Brandon at 425.

²⁵ Above.

²⁶ Above, at 422.

Applying *The Lips* to *Sprung*

- 2.30 We think that *The Lips* reached a fair result. The litigants were sophisticated commercial people who had allocated the risks of exceeding lay-days in their contract. Indeed, the charter party specifically considered the risks of currency fluctuations and set the exchange rate for the date of the bill of lading. It was right that the parties should be bound by their agreement and that the courts should not provide additional damages.
- 2.31 This, however, does not mean that the approach is fair when applied to Mr Sprung. In *Sprung*, Lord Justice Evans commented:

Mr Sprung is entirely correct to say that this is not a claim for demurrage and that precisely the same considerations with regard to the claim accruing do not arise. But the more general statement, “There is no such thing as a cause of action in damages for late payment of damages”, has to be accepted, as Hirst J later found, as applying also to a claim for payment under an insurance policy, such as this one is.²⁷

- 2.32 We think this approach is unduly technical. *The Achilleas* establishes that the losses for which a contract breaker is liable should be determined by looking at the commercial context of the contract. It is important to bear in mind what reasonable people in the position of the parties would have thought they were paying for. The fact that the parties in *The Lips* had agreed fixed (and limited) damages for exceeding lay days does not mean that Mr Sprung had agreed to assume the risk that his insurers would refuse to pay him for almost four years.

An increasingly anomalous decision

The law should provide an effective remedy

- 2.33 Fifty years ago, the rule that an insurer should not be liable to a policyholder for a failure to pay a claim may not have seemed so out-of-step with general contract principles. The decision in *Sprung*, however, is increasingly anomalous in light of contemporary developments in English common law.
- 2.34 For example, some early nineteenth century cases suggested that the general rules on damages were limited in circumstances where one party has failed to pay money owed.²⁸ In 2007, however, the House of Lords re-examined this area of law in *Sempra Metals v Inland Revenue*.²⁹ Lord Nicholls started with “the broad proposition of English law” that a claimant can recover damages for losses caused by a breach of contract or a tort which satisfy the usual tests for remoteness. Previously, the common law had provided that claims for interest losses by way of damages for breach of contract to pay a debt were not

²⁷ *Sprung v Royal Insurance (UK) Ltd* [1999] Lloyd’s Rep 111, p 75.

²⁸ *Page v Newman* (1829) 9 B & C 378 and *London Chatham and Dover Railway Company v South Eastern Railway Company* [1893] AC 429, at p 438.

²⁹ *Sempra Metals (formerly Metallgesellschaft Limited) v Commissioners of Inland Revenue* [2007] UKHL 34, [2008] 1 AC 561.

available. Lord Nicholls described this rule as “an anomalous, that is, unprincipled, exception”.³⁰ Instead:

those who default on a contractual obligation to pay money are not possessed of some special immunity in respect of loss caused thereby.³¹

He added:

In principle, it is always open to a claimant to plead and prove his actual interest losses caused by late payment of a debt. These losses will be recoverable, subject to the principles governing all claims for damages for breach of contract, such as remoteness, failure to mitigate, and so forth.³²

- 2.35 *Sempra Metals* involved a claim for restitution and not contract damages, and did not deal with insurance law. Nonetheless, here, it was felt that damages for losses suffered by one party for the other’s breach ought to be effective, sufficiently compensatory, and should not be limited by common law exceptions that give rise to unjust results. In our view, it provides a robust logic that leaves the rule in *Sprung* increasingly isolated.

Financial inability does not break the chain of causation

- 2.36 The main reason why Mr Sprung did not repair his factory was that he could not afford to do so without the insurance payment. It has long been held that it is the duty of a victim of a breach of contract to mitigate the loss by taking all reasonable steps to reduce its scale. A difficult question arises when the victim cannot afford to take the steps necessary.

- 2.37 In 1933, the House of Lords took the very harsh line that if a victim is unable to mitigate a loss for lack of money, the law should not compensate for “impecuniosity”, which may be regarded as “a separate and concurrent cause”.³³ This is, however, no longer good law. In *Lagden v O’Connor* the House of Lords held that lack of funds should not be regarded as some extraneous factor.³⁴ Instead the normal foreseeability test applies. As Lord Hope put it, the law:

requires the wrongdoer to bear the consequences if it was reasonably foreseeable that the injured party would have to borrow money or incur some other kind of expenditure to mitigate his damage.³⁵

³⁰ Above, at [74].

³¹ Above, at [93].

³² Above, at [94].

³³ *The Liesbosch Dredger (Owners of) v Owners of SS Edition (The Liesbosch)* [1933] AC 449 at 460.

³⁴ [2003] UKHL 64; [2004] 1 AC 1067.

³⁵ [2003] UKHL 64; [2004] 1 AC 1067.

- 2.38 Again, we do not think the decision in *Lagden v O'Connor* overrules the decision in *Sprung*; the central “hold harmless” fiction behind *Sprung* remains unaffected. We believe, however, that the decision in *Sprung* has become increasingly out of step with wider principles of contract law.

APPLYING *SPRUNG* IN SUBSEQUENT CASES

- 2.39 Since 1999, *Sprung* has been cited in at least six High Court decisions. Five cases were claims against insurers and in all five, *Sprung* was applied to deny claimants the possibility of damages for late payment. In the sixth case, *Sprung* was held not to apply to a claim against an insurance broker and the claimant was awarded substantial damages.³⁶ All six cases are discussed below.

There is no implied term to pay within a reasonable time

- 2.40 In *Sprung*, the Court of Appeal left open the possibility that if the insurer could be found to have breached a separate obligation, then a claim for damages could arise. Lord Justice Evans said:

If as a matter of law the plaintiff is able to show that the defendants have committed some other and separate breach of contract, and if specifically he can show that the defendants were in breach by failing to accept liability or to approve of the reinstatement at an early stage, then the recovery of damages would not be restricted to the discretionary award of interest which exists in the other case.³⁷

- 2.41 This opened the possibility that if an insurance policy contains a specific term that the insurer should pay a claim within a reasonable time, then damages may be attached to the breach of that specific term.
- 2.42 In three High Court cases, claimants attempted to argue that the insurer had an implied term to pay within a reasonable time, and claimed for damages when the insurer did not do so. They failed.
- 2.43 In *Insurance Corporation of the Channel Islands Ltd v McHugh*,³⁸ the policyholders owned a hotel which suffered three arson attacks. The insurers refused to pay the policyholders’ claims under the fire and business interruption insurance, alleging various frauds by the policyholders. The policyholders argued that the insurers had breached an implied term to conduct the negotiations, assess the claim and pay any sum due with reasonable diligence and expedition. As a result of the insurer’s breach, the policyholders argued that the hotel was unable to recommence business and had suffered loss.
- 2.44 Mr Justice Mance specifically rejected the argument that such a term should be implied:

³⁶ *Arbory Group v West Craven Insurance Services* [2007] PNL R 23, discussed below at 2.55 to 2.58.

³⁷ *Sprung v Royal Insurance (UK) Ltd* [1999] Lloyd’s Rep IR 111, 116.

³⁸ [1997] 1 Lloyd’s Rep IR 94.

The law will not ... imply a term unless it is necessary to give the contract business efficacy or represents the obvious, although unexpressed, intention of the parties. Mere reasonableness or convenience is not sufficient.³⁹

- 2.45 Even where an insurance policy appears to include an express term to pay claims promptly, the courts have been reluctant to accept it. In *Tonkin v UK Insurance Ltd*,⁴⁰ a household policy contained the following:

“We will always try to be fair and reasonable whenever you have need of the protection of this Policy. We will also act quickly to provide that protection.”

- 2.46 After a fire, the insurers and the policyholder became embroiled in a lengthy dispute. Three and a half years later, the property still had not been rebuilt. The policyholders argued that the insurers had not acted quickly to provide the protection as promised, and as a result they suffered further loss.

- 2.47 The judge rejected the claim. Citing *Sprung* and *The Italia Express*, he held that a claim for damages for delay would effectively amount to damages on damages. This, the judge noted, “is just the sort of claim which the authorities noted above hold to be invalid”.⁴¹ At the same time, the judge accepted that the matter was not entirely clear cut for the reasons identified by Lord Justice Evans in *Sprung*. Nevertheless, he found no reason in this case to award damages for breach of contract.

- 2.48 In a lecture, Lord Mance commented on the case of *Tonkin* saying that whilst the policy wording in that case may have been insufficiently clear, Lord Justice Evans’s statement might seem to open the door to clauses such as clause 46.7 of the International Hull Clauses 2003.⁴² Clause 46.7 provides:

The Leading Underwriter(s) shall make a decision in respect of any claim within 28 days of receipt by them of the appointed average adjuster’s final adjustment or, if no adjuster is appointed, a fully documented claim presentation sufficient to enable the Underwriters to determine their liability in relation to coverage and quantum.⁴³

³⁹ Above, at 136. It should be noted that, on the facts, it was found that the policyholders had committed fraud.

⁴⁰ [2006] EWHC 1120 (TCC), [2006] 2 All ER (Comm) 550.

⁴¹ Above, at 38.

⁴² Lord Donaldson memorial lecture, delivered by Lord Mance to mark the Centenary of the Joint Hull Committee, in the Old Library at Lloyd’s on 10 November 2010; published August 2011, Lloyd’s Maritime and Commercial Law Quarterly.

⁴³ The clause continues: “If the Leading Underwriter(s) request additional documentation or information to make a decision, they shall make a decision within a reasonable time after receipt of the additional documents or information requested or of a satisfactory explanation as to why such documents and information are not available”.

- 2.49 The clause creates on its face a contractual obligation to pay within a certain time. Although the consequences of the breach are not spelt out, Lord Mance is of the view that if the loss can be proved, damages are likely to be recoverable. He does not see that clause 46 will fall foul of the common law rule against damages for late payment of damages as clause 46 creates a freestanding obligation.⁴⁴ He adds that clause 46.7 is new and this principle would not apply to earlier Institute Time Clauses (Hulls) which did not contain “time for payment” clauses. These clauses, he considers, would probably be caught by the common law which precludes damages for late payment of insurance claims.
- 2.50 In *Normhurst Ltd v Dornoch Ltd*,⁴⁵ the claimants’ business property was damaged in a fire. When the insurers avoided the policy by alleging non-disclosure, the claimants brought various claims, including a claim for damages for the insurers’ refusal to pay. The insurers made an application to strike out this claim at a preliminary hearing. There, the judge applied *Sprung*, which he described as “considered, unanimous, and entirely in point”.⁴⁶
- 2.51 The claimants argued that the “hold harmless” analysis was inconsistent with the specific wording of the insurance policy. The insurance policy had made reference to the insurers’ liability to make a payment,⁴⁷ yet the judge held that he had to look “at substance not form” of the insurers’ liability. In other words, the judge reasoned that the substance of the contract was that the insurers undertook to prevent the fire, even if the contract had described the insurers’ duty in terms of liability to pay claims.

The rule in *Sprung* appears “settled”

- 2.52 In *England v Guardian Insurance Ltd*,⁴⁸ Mr and Mrs England suffered damage to their house as a result of piling on a neighbouring property. They claimed under their buildings insurance, but the insurers denied liability. After proceedings were issued against several parties (including the engineer and the site owner), Mr and Mrs England received damages from the insurers and engineers. However, they were still left to meet £40,000 in costs.
- 2.53 One issue was whether the insurers’ payment covered the damage to the house, or whether it also included damages for distress and inconvenience and other irrecoverable costs. The judge applied *The Italia Express* and *Sprung*, and held that the full amount of the insurers’ payment must have been for the damage to the house, as no other heads of damage were recognised at law. He explained:

⁴⁴ Lord Mance says that he is supported in this view by Professor Howard Bennett (*The Law of Marine Insurance* (2nd ed 2006), who sees “no impediment to the parties agreeing express contractual time limits for processing and paying claims” and the authors of *Arnould’s Law of Marine Insurance and Average* (17th ed 2008), [27.02], n 17 who comment that “the courts are unlikely to treat clause 46 as a means of circumventing the rule against compensation for late payment of the assured’s indemnity”.

⁴⁵ [2004] EWHC 567 (Comm), [2005] Lloyd’s Rep IR 27.

⁴⁶ Above, at [8].

⁴⁷ The policy imposed conditions on the insured which were described as “a condition precedent to any liability of the Underwriters to make any payment”.

⁴⁸ [1999] 2 All ER (Comm) 481.

Non-payment gives rise to a claim for the debt and to an entitlement to interest but not to an additional claim for damages. In the context of a house and home policy, this approach may appear unduly technical but it is based on a long line of authority.⁴⁹

- 2.54 In *Mandrake v Countrywide Assured Group*,⁵⁰ the insurer also applied to strike out a claim for damages for late payment. In the Court of Appeal, the claimant's counsel accepted that both the High Court and Court of Appeal were bound by *Sprung*. Lord Justice Rix considered that if the issue was reviewed by the House of Lords, it "may well lead to some clarification and amendment of the law".⁵¹ The Court of Appeal, however, thought that the House of Lords should decide whether to give leave for an appeal to the House of Lords, and the House of Lords refused leave.⁵²

Damages for non-payment are available against insurance brokers

- 2.55 We have seen five cases in which the courts have found themselves bound by the "hold harmless" principle. The case of *Arbory Group v West Craven Insurance Services*⁵³ is different.
- 2.56 The claimant had asked its insurance brokers to arrange for business interruption insurance, but the brokers acted negligently and failed to advise the business about how to assess their gross profit for insurance. The result was that the business was significantly underinsured. After a major fire, the claimant did not receive the anticipated business interruption payments. Unable to resume trading, it suffered loss of profits. The High Court was asked to decide how much the brokers should compensate the business: should damages be limited to merely the payments the claimant would have received if it had not been underinsured, or should the brokers pay for the further loss of profits?
- 2.57 The defendant brokers argued that payment for the further loss would be "tantamount to awarding damages for the non-payment of damages" contrary to the rule in *Sprung*. The judge rejected this, and found that the brokers should pay for the further loss. He noted that business interruption cover is designed to provide funds at a vulnerable time, and without these funds it was reasonably foreseeable that the company would suffer further loss.⁵⁴
- 2.58 The case shows the potential effect of reversing the rule in *Sprung*. It suggests that in a contract for business interruption insurance, in particular, the parties may contemplate business failure as a foreseeable consequence of the non-payment of a claim. Thus, under the ordinary rules of *Hadley v Baxendale*, the losses incurred by business failure may therefore be regarded as foreseeable losses.

⁴⁹ [1999] 2 All ER (Comm) 481 at [73].

⁵⁰ [2005] EWCA Civ 840.

⁵¹ Above, at [25].

⁵² The House of Lords refused leave to appeal on 10 November 2005.

⁵³ *Arbory Group v West Craven Insurance Services* [2007] Lloyd's Rep IR 491.

⁵⁴ Above, at 497.

EXCEPTIONS TO THE RULE IN *SPRUNG*

- 2.59 Claims against brokers appear to be one exception to the prohibition on claiming damages for the failure to pay an insurance claim. There are two other significant exceptions. The first is for non-indemnity insurance such as life insurance: claims under life insurance policies have been characterised as contract debts so that the normal rules of contract apply.⁵⁵
- 2.60 Secondly, the rule does not apply where the insurer has undertaken to reinstate property. Insurance policies often allow insurers to choose between payment or “reinstatement” (that is, repairing or replacing the damaged property). If an insurer elects to reinstate, it acquires obligations in relation to the quality of that reinstatement, which are similar to the general obligations on suppliers of goods and services. In particular, the insurer may face liability in damages for the foreseeable loss caused to a policyholder if it fails to reinstate the property within a reasonable time. As we discuss in Part 3, in consumer claims the insurer may be liable to pay limited damages for distress and inconvenience.
- 2.61 These complex distinctions are hard to understand and justify.

DAMAGES FOR LATE PAYMENT IN SCOTS LAW

- 2.62 The law of Scotland in this area is different from the law of England and Wales. The starting point for the Scots law analysis is that the insurer’s obligation is characterised as a contractual duty to pay a sum of money equivalent to the insured’s loss.⁵⁶
- 2.63 As a result, an insurance payment is a contractual claim, subject to the common law rules of foreseeable loss as set out in *Hadley v Baxendale*. In *Scott Lithgow Ltd v Secretary of State for Defence*,⁵⁷ Lord Keith noted that:
- It is to be observed in passing that Scots law has not adopted the English view that the right of action in the event of non-payment under a policy of insurance is one for unliquidated damages. [The pursuer’s] right of action is here a contractual one, not one in reparation.⁵⁸
- 2.64 Under English law, the insurer is in breach of contract as soon as the loss occurs.⁵⁹ Under Scots law, however, the insurer is not obliged to pay the insured until a claim is made. Even then, the insurer is not required to pay immediately. Instead, authority suggests that the insurer must first have an opportunity to investigate a claim.

⁵⁵ *Blackley v National Mutual Life Assn Ltd (No 2)* [1973] NZLR 668.

⁵⁶ *Carrick Furniture House Ltd v General Accident Fire and Life Assurance Corp Ltd* 1977 SC 308; *Scott Lithgow Ltd v Secretary of State for Defence* 1989 SC (HL) 9; *Anderson v Commercial Union Assurance Co Plc* 1998 SLT 826; *Strachan v The Scottish Boatowners’ Mutual Insurance Association* 2010 SC 367.

⁵⁷ 1989 SC (HL) 9.

⁵⁸ Above, at [20].

⁵⁹ See above at 2.19.

2.65 In *Strachan v The Scottish Boatowners' Mutual Insurance Association*,⁶⁰ Mr Strachan's fishing boat was damaged at sea and brought back to port by salvors. His insurers refused to indemnify him for the cost of repairs on the basis that the boat had been unseaworthy before it was taken out. For three years, the damaged boat remained arrested by the salvors. During this time, its condition deteriorated beyond repair. Lord Eassie distinguished the Scots position from the English approach:

It was clear under Scots law that that point in time [when the insurer came under obligation to make payment] could not be said to be the moment of the casualty. Before an obligation to pay could crystallise there had to be first the making of the claim. The insurer then had to have an opportunity to investigate its soundness, the insurer's obligation being only to pay upon a valid claim.⁶¹

2.66 This approach seems more consistent with the realities of the situation. The insurer's obligation does not arise from the moment the harm occurs, but arises when the insured has made a valid claim and the insurer has had an opportunity to investigate the claim. Thus the insurer is in breach of its contractual obligations where it pays only after unjustifiable delay, or where it wrongfully repudiates the claim. The time period within which payment must be made may be specified in the insurance policy. In the absence of such an express term, the courts can imply a term that the claim should be paid within a reasonable time.

2.67 As we have seen, the English courts have refused to recognise an implied term that the insurer should assess a claim reasonably and with diligence. By contrast, in the Scottish case of *Alonvale Ltd v J M Ing*,⁶² it was accepted that there was such an implied term. In that case, the policyholder's business premises had burned down. When the insurers failed to pay, the policyholder claimed for lost profits from the time the building should have been reinstated. The court accepted that there was an implied term to pay within a reasonable period of time. As the insurer had breached this obligation, the question of potential liability for loss caused by the breach arose.⁶³

⁶⁰ *Strachan v The Scottish Boatowners' Mutual Insurance Association* 2010 SC 367.

⁶¹ Above, by Lord Eassie at [36].

⁶² 1993 GWD 36-2345.

⁶³ For further discussion of Scots law, see Insurance Contract Law Issues Paper 6: Damages for Late Payment and the Insurer's Duty of Good Faith (March 2010) paras 3.10 to 3.13.

***Hadley v Baxendale* applied to late payment**

- 2.68 In Scots law, the normal remedy for late payment under a contract is interest on the sum from the date that it became due; however, there is no rule that interest will be the only redress for consequential loss suffered as a result of the late payment of money.⁶⁴ Wider recovery of damages will be open to a pursuer who can show that the loss was reasonably foreseeable within the rules in *Hadley v Baxendale*.⁶⁵
- 2.69 It is notable, however, that the Scottish courts have taken a cautious approach in interpreting the test for foreseeable loss, and the courts have consistently upheld the need for damages to fall into one of the two branches of *Hadley v Baxendale*. Consider, for example, how the test for foreseeable loss was applied in *Alonvale Ltd v J M Ing*.⁶⁶ There, the pursuer's business was financed by loans and was relatively financially vulnerable. The court found that there was an implied term to pay a valid claim promptly, and that the insurers had breached this obligation. However, the claimant's loss of profits arising from its financial vulnerability was not held to be within the insurer's reasonable contemplation.
- 2.70 In summary, the Scots law approach to damages for late payment of insurance claims has followed ordinary contract principles. An insurer's primary obligation is to pay a valid claim following a reasonable time for investigation. Thus, an insurer who unjustifiably delays payment or wrongfully repudiates a claim is considered to be in breach of contract which opens the possibility that the insurer may be liable for losses which the insured has suffered and which fall within one or other branch of the rule in *Hadley v Baxendale*. In the Scottish experience, the test for foreseeable loss has been interpreted restrictively.⁶⁷
- 2.71 We think that this approach is more logical than the legal fiction of the "hold harmless" principle which afflicts this area of English law.

DAMAGES FOR DISTRESS AND INCONVENIENCE

- 2.72 It is also worth considering an additional common law remedy which is relevant to consumer insurance contracts. In addition to financial and other foreseeable losses, unreasonable delay by the insurer in making a payment is likely to cause distress and inconvenience to the policyholder.

⁶⁴ *Strachan v The Scottish Boatowners' Mutual Insurance Association* 2010 SC 367.

⁶⁵ (1854) 156 ER 145, as now explained by the House of Lords in *Transfield Shipping Inc of Panama v Mercator Shipping Inc of Monrovia (The Achilleas)* [2008] UKHL 48, [2009] 1 AC 61, which has been cited on a number of occasions in Outer House cases, for example *Donoghue v Greater Glasgow Health Board* [2009] CSOH 115, 2009 GWD 27-432; *Beaghmor Property Limited v Station Properties Limited* [2009] CSOH 133, 2009 GWD 35-589; and *Upton Park Homes Ltd v Macdonalds Solicitors* [2009] CSOH 159, 2010 GWD 3-38, [2010] PNLR 12. See further, Insurance Contract Law Issues Paper 6: Damages for Late Payment and the Insurer's Duty of Good Faith (March 2010) paras 3.14 to 3.18.

⁶⁶ 1993 GWD 36-2345.

⁶⁷ See Insurance Contract Law Issues Paper 6: Damages for Late Payment and the Insurer's Duty of Good Faith (March 2010) paras 3.15 to 3.18.

Distress and inconvenience damages in general consumer contracts

2.73 The general principle of contract law is that compensation is only awarded for financial loss or physical injury. However, in England and Wales, in consumer contracts, this is subject to two exceptions:

- (1) Where the object of the contract is to give pleasure, relaxation or peace of mind, the courts have been willing to award damages for distress and inconvenience where the contract is breached.⁶⁸ An example is *Jarvis v Swan Tours*,⁶⁹ where the claimant was entitled to recover damages for the disappointment of a disastrous ski holiday.⁷⁰
- (2) Damages may be awarded where a consumer has suffered some physical inconvenience or discomfort. The typical example is where the consumer is forced to live in a damaged house. Thus damages are commonly awarded where a landlord has failed to repair the accommodation where the tenant lives.⁷¹

2.74 In Scots law too, damages may be awarded for trouble and inconvenience resulting from a breach of contract.⁷² Trouble and inconvenience extends beyond physical inconvenience and discomfort in so far as it can include matters such as protracted correspondence resulting from the breach.⁷³ Damages can also be awarded in Scotland where the purpose of the contract is to give pleasure, relaxation or peace of mind.⁷⁴

2.75 The courts in England and Wales have consistently stressed that distress damages should be low. In *Farley v Skinner*, the court awarded £10,000 but this was described as “at the very top end of what could possibly be regarded as appropriate damages”.⁷⁵ Recently, in *Milner v Carnival*,⁷⁶ Lord Justice Ward confirmed that awards in this area should be “restrained and modest”. In Scotland, a lack of recent awards under this head of damages makes it more difficult to be clear about the stance that the courts there would take, although we think it unlikely that they would differ much from their English counterparts.

⁶⁸ See *Farley v Skinner* [2001] UKHL 49, [2002] 2 AC 732.

⁶⁹ [1973] QB 233.

⁷⁰ For other examples, see *Jackson v Horizon Holidays* [1975] 1 WLR 1468 CA and *Milner v Carnival Plc (trading as Cunard)* [2010] EWCA Civ 389, [2010] 3 All ER 701.

⁷¹ See, for example, *Wallace v Manchester City Council* [1998] 3 EGLR 38. In Scots law, see *Mack v Glasgow City Council* 2006 SC 543.

⁷² *Webster & Co v Cramond Iron Co* (1875) 2R 752; *Wilkie v Brown* 2003 SC 573; *Mack v Glasgow City Council* 2006 SC 543.

⁷³ *Aarons & Co Ltd v Fraser* 1934 SC 137, by Lord Murray at p 143; *Webster & Co v Cramond Iron Co* (1875) 2R 752. Note also that, in Scotland, “inconvenience” does not generally extend to emotional reaction falling short of recognised psychiatric illness. See *Simpson v Imperial Chemical Industries Ltd* 1983 SLT 601 and *Simmons v British Steel Plc* 2004 SC (HL) 94.

⁷⁴ See Scottish Law Commission Report No 174 on Breach of Contract (1999), para 3.3; WW McBryde, *Contract*, at paras 22-104 to 22-105. Examples include *Diesen v Samson* 1971 SLT (Sh Ct) 49; *Colston v Marshall* 1993 SCLR 43.

⁷⁵ [2001] UKHL 49, [2002] 2 AC 732, by Lord Steyn at 751.

⁷⁶ [2010] EWCA Civ 389, [2010] 3 All ER 701.

Distress and inconvenience damages in insurance law

- 2.76 Insurance law makes a sharp distinction between cases where an insurer agrees to reinstate property, and cases where the insurer refuses the claim completely. Where an insurer agrees to repair the consumer's home, but then leaves the property in a state of disrepair for an unreasonably long time, the courts have awarded limited damages. In *AXA Insurance UK Plc v Cunningham Lindsey UK*,⁷⁷ the consumers experienced serious delays in reinstating their home. The insurers settled the consumers' claim for distress and inconvenience for £92,000 and then brought a claim against their own loss adjusters for professional negligence. The judge ruled that £92,000 was too much, and could not be recouped from the loss adjusters. However, the insurers were liable for some damages in these circumstances: probably no more than £1,800 per person per year.
- 2.77 By contrast, if the insurer fails to entertain the claim at all, the English courts have held that no damages should be awarded. It would appear that even if *Sprung* were to be reversed, and policyholders were able to recover financial loss, there would still be a specific prohibition against damages for distress and inconvenience in such circumstances. In *England v Guardian Insurance Ltd*, for example, the judge noted that:
- Distress and inconvenience damages are only awarded as damages for breach of contract where the contract is one to provide personal service or enjoyment to the plaintiff, such as are provided by professionals or holiday companies.⁷⁸
- 2.78 This was a consumer insurance claim, and consumer insurance is often sold specifically to provide peace of mind. We see no reason why damages for distress and inconvenience should not be available where an insurer breaches a consumer insurance contract, provided that such damages meet the normal rules and are "restrained and modest".⁷⁹ It may be that the decisions of the English courts, in cases such as *England v Guardian Insurance Ltd* not to award damages on the basis of inconvenience, are narrower than the approach which would be open to the Scottish courts.⁸⁰
- 2.79 Notably, the FOS requires an insurer to compensate the consumer for the distress and inconvenience they have suffered. The amounts awarded in such cases tend to be low. The decisions we examined in a sample analysis ranged from an order to send flowers, to awards of £300 to £999 ("significant" compensation), to awards exceeding £1,000 ("exceptional" compensation). We provided some case examples in Issues Paper 6.⁸¹ "Significant" compensation of between £300 and £999 was awarded where a travel insurer wrongly refused to approve life saving surgery and the consumer was forced to pay for it.

⁷⁷ [2007] EWHC 3023 (TCC).

⁷⁸ [1999] 2 All ER (Comm) 481, at [74].

⁷⁹ *Milner v Carnival Plc (trading as Cunard)* [2010] EWCA Civ 389, [2010] 3 All ER 701 by Lord Justice Ward.

⁸⁰ See para 2.74 above.

⁸¹ Insurance Contract Law Issues Paper 6: Damages for Late Payment and the Insurer's Duty of Good Faith (March 2010) paras 6.5 to 6.7.

“Exceptional” compensation of over £1000 was provided to an elderly couple who had waited five years for the subsidence in their home to be repaired.⁸²

- 2.80 The insurance industry appears to accept the approach taken by the FOS. Insurers seem willing to pay small amounts to compensate consumers for distress and inconvenience in appropriate cases. In Part 5 we propose that the law should be reformed to reflect the approach already adopted by the FOS, which is to provide limited damages for distress and inconvenience in appropriate cases.

LIMITATION AND PRESCRIPTION

- 2.81 The different ways in which English and Scots law characterise the insurer’s obligations has implications for limitation and prescriptive periods. When do those periods start to run?
- 2.82 The law requires that a claim is brought within six years (in England and Wales) or five years (in Scotland) of the breach of contract.⁸³
- 2.83 In English law, under the “hold harmless” principle, the insurer is considered to be in breach as soon as the harm occurs and thus the time begins to run at that date. For example, in *Callaghan v Dominion Insurance Co*,⁸⁴ the claimants suffered fire damage at their insured discotheque in 1989 and the insurers avoided the policy on the grounds of non-disclosure in 1990. The claimants issued proceedings against the insurers in 1996 seeking payment of the claim, but the court found that the insureds were time barred. The limitation period arose from the date of the loss (when the insurers were technically in breach of contract) and thus expired in 1995. The court rejected the claimants’ argument that the breach of contract did not occur until the insurer avoided the contract in 1990.
- 2.84 This contrasts with the position under Scots law where, in general, prescription begins to run, not from the time of a wrongful act, but from the date of the loss following from that wrong.⁸⁵ Where there has been a wrongful repudiation of contract by the insurer however, it is highly likely that loss will flow immediately from the wrong.⁸⁶ Where the breach of contract consists of the insurer’s unjustifiable delay, it would appear consistent with general principles that the

⁸² Recently the FOS indicated that such awards have increased. Some 20,019 pay-outs for “distress and inconvenience” were ordered by the FOS in 2010-11, up 1,508 on the previous year. See <http://www.bbc.co.uk/news/business-13222383>.

⁸³ Limitation Act 1980, s 5; Prescription and Limitation (Scotland) Act 1973, s 6.

⁸⁴ *Callaghan v Dominion Insurance Co Ltd* [1997] 2 Lloyd’s Rep 541 (QBD).

⁸⁵ Prescription and Limitation (Scotland) Act 1973, s 6(3). The prescriptive period is five years.

⁸⁶ D Johnston, *Prescription and Limitation* (1999), para 4.11. It has been held that where loss arises following the non-wrongful repudiation by insurers of an insurance contract, but that loss is alleged to flow from the negligence of the brokers who placed the insurance, the latter’s act, neglect or default must have taken place at the time the contract was concluded, and the loss at the time of the repudiation: *Arif v Levy & McRae*, Lord Coulsfield, December 17, 1991, unreported; cited in Johnston, *Prescription and Limitation* at para 4.45(1). Prescription therefore took effect against a claim by the insured against his brokers five years from the date of repudiation.

prescriptive period can begin to run only after the passing of a reasonable time for investigation of the claim.⁸⁷

- 2.85 It has also been noted that insurance contracts typically contain provisions on the steps the insured must take after the occurrence of an insured peril.⁸⁸ In Scots law, it will be a question of construction of the contract as to whether those provisions amount to conditions suspensive of the insurer's obligation to make payment under the policy. If they do, the obligation to make payment will begin to prescribe not from the date of the loss but from the date when the conditions in question are purified.⁸⁹
- 2.86 In Part 5 we propose to recharacterise the insurer's duty as one to pay a valid claim within a reasonable time. This has implications for the limitation period under English law, which we will discuss in Part 5.

CONCLUSION

- 2.87 In English law, policyholders are not entitled to damages for an insurer's failure to pay an insurance claim within a reasonable time (or at all). This rule is out of line with ordinary contract principles: it rests on the legal fiction that an insurer undertakes to prevent a loss from occurring. In reality, insurers do not undertake to prevent losses, but to pay defined sums of money if particular losses occur. The rule also appears unique. It has not been followed in Scotland or in other common law jurisdictions. Nor is it applied against brokers, in contracts for life insurance, or where an insurer undertakes to reinstate property. In Part 4 we argue that the rule is unprincipled and unfair, and should be reformed.
- 2.88 In the next Part we will briefly consider other possible routes to redress and explain why they are not an adequate substitute for law reform in this area.

⁸⁷ See *Strachan v The Scottish Boatowners' Mutual Insurance Association* 2010 SC 367 in which Lord Eassie accepted the argument that the point at which the insurer's obligation crystallised did not occur until the insurer had been given a period of time in which to carry out investigations.

⁸⁸ D Johnston, *Prescription and Limitation* (1999), at para 4.15.

⁸⁹ Above.

PART 3

DAMAGES FOR LATE PAYMENT: OTHER ROUTES TO REDRESS

3.1 As we discussed in Part 2, the English treatment of insurance contracts is out of step with the ordinary contract principles on damages. If an insurer wrongly delays or refuses payment, a policyholder who suffers loss has no remedy other than a claim for interest. In this Part we consider three other possible routes to redress which might be open to a policyholder. As we will explain, none of them are sufficient alternatives to legislative reform:

- (1) An insurer who fails to pay a claim it knows to be valid may be in breach of its duty of good faith. However, the courts have held that this does not give the policyholder a right to claim damages. The only remedy is the right to avoid the policy, which is of little use to a policyholder who wishes a claim to be paid. The duty of good faith is said to be a shield rather than a sword: it may be used to curb the way that an insurer exercises an apparent right, but it does not give rise to a stand-alone claim for damages.
- (2) An insurer who fails to handle claims “promptly and fairly” breaches Financial Services Authority (FSA) rules. This may give the policyholder the right to damages for breach of statutory duty under section 150 of the Financial Services and Markets Act 2000 (FSMA 2000). This right is, however, only available to individuals and those groups who are not carrying on business of any kind.¹ It is also a complex and difficult cause of action which has been little used in practice. We do not think it is a substitute for law reform.
- (3) Consumers and some small businesses have the right to complain to the Financial Ombudsman Service (FOS). The FOS frequently awards damages for loss caused by poor complaints handling. In Part 5 we propose to bring the law for consumers into line with the approach already taken by the FOS.

3.2 The issues are discussed in our Issues Paper in greater depth;² here we provide only a general outline. In Issues Paper 6, we explained that a policyholder also has the right to statutory interest for late payment of a debt. We are not making changes to the interest arrangements and do not discuss them here.³

¹ Section 150(1) of the Financial Services and Markets Act 2000 limits the right of action to a “private person who suffers loss as a result of the contravention”. The definition of a private person is expanded upon in the Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001 to include any person who “is not an individual, unless he suffers the loss in question in the course of carrying on business of any kind “(SI 2001 No 2256, Reg 3).

² Insurance Contract Law Issues Paper 6: Damages for Late Payment and the Insurer’s Duty of Good Faith (March 2010), Part 4.

³ The right to statutory interest differs between England and Wales on the one hand and Scotland on the other. For more detail, see Issues Paper 6 (above), paras 5.2 to 5.15.

DAMAGES FOR BREACH OF THE INSURER'S DUTY OF GOOD FAITH

- 3.3 Section 17 of the Marine Insurance Act 1906 imposes mutual obligations both before and after a contract is formed. It states:

A contract of marine insurance is a contract based upon the utmost good faith, and, if the utmost good faith be not observed by either party, the contract may be avoided by the other party.

- 3.4 This raises the question of whether an insurer would breach its duty of good faith if it unreasonably delayed payment or refused a claim it knew to be valid. If so, is the policyholder entitled to damages? In theory, it is possible that a refusal to pay a claim for no good reason would be a breach of the duty of good faith. In *The Star Sea*,⁴ the House of Lords described the post-contract duty of good faith as flexible and variable. As Lord Clyde put it:

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.⁵

- 3.5 Even if such behaviour does amount to a breach of the duty of good faith, the courts have held that the insured is not entitled to damages. Under section 17, the only remedy available for breach of good faith is avoidance of the policy. This means that the contract is declared to be void from the start.
- 3.6 This is a wholly one-sided remedy in favour of the insurer. If an insurer was in breach of its part of the mutual duty, it is completely implausible that an insured would seek to undo the contract. Instead, a policyholder would hope to receive payment under the insurance policy and any additional damages for losses suffered. In other words, under the current law, the only available remedy for breach of good faith is inherently of little use to the insured.
- 3.7 The case of *Banque Financiere v Westgate Insurance Co* is instructive.⁶ Here Lord Justice Slade unequivocally denied that damages were available for the insurer's breach of good faith, even where avoidance "may be quite inadequate" as a remedy for the policyholder.⁷ Though the case related to pre-contract non-disclosure, the reasoning that damages are not available for breach of the duty of good faith has been entrenched in subsequent case law. In *HIH v Chase Manhattan*, Lord Justice Rix held that:

⁴ *Manifest Shipping & Co Ltd v Uni-Polaris Insurance Co Ltd ("The Star Sea")* [2001] UKHL 1, [2003] 1 AC 469.

⁵ Above, at [7].

⁶ *Banque Keyser Ullmann SA v Skandia (UK) Insurance Co Ltd* [1990] 1 QB 665, later approved by the House of Lords in *Banque Financiere de la Cite SA v Westgate Insurance Co Ltd* [1991] 2 AC 249. For a thorough discussion of the case, see Insurance Contract Law Issues Paper 6: Damages for Late Payment and the Insurer's Duty of Good Faith (March 2010), paras 4.24 to 4.45.

⁷ Above, at 775.

The duty of good faith which the law had developed especially for contracts of insurance provides a remedy only in avoidance and not in damages.⁸

Good faith as a backstop

- 3.8 As we have seen, it appears that the duty of good faith does not provide policyholders with a claim for damages against insurers. Rather the duty is a principle by which other obligations in the insurance contract should be interpreted. As we explore below, this appears to be the view in both English and Scots law.

Good faith as a “shield”: the position in Scots law

- 3.9 In *Fagnoli v GA Bonus Plc*,⁹ Lord Penrose viewed good faith not as a stand-alone duty, but as a factor which would “colour” the material obligations, express and implied, owed by both parties. He noted that it:

must be open to question whether an insurer would be in good faith in delaying an admission of liability, or in advancing spurious defences to a claim, or to put the insured to proof of what the insurer knows is true, or in delaying settlement of claims which he would, objectively, be obliged to admit before a court to be valid.¹⁰

- 3.10 *Fagnoli* is the only Scottish case of which we are aware which discusses a post-contract duty of good faith in insurance law. More widely, however, this view has seen some other judicial support. Lord Hope of Craighead has explained that good faith rarely founds a direct claim as it lacks “an active or creative nature”.¹¹ This view has also seen academic support in Scots law. Professor McBryde summarises the approach taken in Scots law as follows:

Good faith is usually a shield and not a sword – it is a defence to an action and not the foundation of an action.¹²

The English decisions: limiting the way an insurer exercises its rights

- 3.11 In an increasing number of English court decisions, insurers have been prevented from exercising an apparent right because the right was not exercised in good faith.

⁸ *HIH Casualty and General Insurance Ltd v Chase Manhattan Bank* [2001] EWCA Civ 1250; [2001] 2 Lloyd’s Rep 483 at [68]. This point was not overturned in the subsequent appeal: *HIH Casualty and General Insurance Ltd v Chase Manhattan Bank* [2003] UKHL 6, [2003] 1 All ER (Comm) 349.

⁹ 1997 SCLR 12, [1997] CLC 653. For further discussion of this case, see paras 6.50 to 6.52 below.

¹⁰ Above, at 670 to 671.

¹¹ *R v Immigration Officer at Prague Airport, ex parte European Roma Rights Centre* [2004] UKHL 55, [2005] 2 AC 1 at [60].

¹² WW McBryde, *The Law of Contract in Scotland* (3rd ed 2007), para 17-29.

3.12 For example, in *The Grecia Express*,¹³ the insurer sought to avoid a ship policy for non-disclosure because the insured had a history of undisclosed previous loss arising out of allegedly suspicious circumstances. When the court found that the previous losses had not been suspicious, as the insurer suggested, it held that the insurer could not avoid the policy. Mr Justice Colman commented that avoidance by the insurer “in the face of evidence before the court” would be “quite contrary to their duty of the utmost good faith.”¹⁴ It would be “unconscionable and therefore impermissible”.¹⁵

3.13 The issue was revisited by the Court of Appeal in *Drake v Provident*.¹⁶ This concerned a dispute between two insurers over whether one of the insurers had the right to avoid a policy for non-disclosure. One issue in this complex case was whether, if the defendant had had a right to avoid, that right was subject to good faith. Lord Justice Rix suggested that it was:

The doctrine of good faith should be capable of limiting the insurer's right to avoid in circumstances where that remedy, which has been described in recent years as draconian, would operate unfairly.¹⁷

3.14 The courts have also found that good faith could operate as a backstop to prevent insurers from misusing their contractual rights. In *Eagle Star Insurance Co Ltd v Cresswell*,¹⁸ a clause in a reinsurance policy gave the reinsurers discretion to “take control” of any negotiation or settlement entered into by the insurer. Whilst the Court of Appeal upheld this discretion, it found that this discretion was subject to the duty of good faith:

If, while exercising or refusing to exercise control, the reinsurers act in bad faith, capriciously or arbitrarily, then there is the implied term [to exercise good faith] to protect the reinsured But this protection may not depend only on a term to be implied “for business efficacy”, but may be inherent as a matter of law in the very essence of the reinsurers' mutual obligation of good faith.

3.15 The extent of the insurer's duty of good faith remains uncertain and its development has been described as “embryonic”.¹⁹ These cases suggest, however, that the duty may operate to qualify the way that an insurer exercises its legal rights in some circumstances.

¹³ *Strive Shipping Corporation and another v Hellenic Mutual War Risks Association (Bermuda) Ltd (The Grecia Express)* [2002] EWHC 203 (Comm), [2002] 2 All ER (Comm) 213.

¹⁴ Above, by Colman J at 275.

¹⁵ Above, at 306.

¹⁶ *Drake Insurance Plc v Provident Insurance Plc* [2003] EWCA Civ 1834, [2004] QB 601.

¹⁷ Above, by Rix LJ at [87].

¹⁸ *Eagle Star Insurance Co Ltd v JN Cresswell* [2004] EWCA Civ 602; [2004] 2 All ER (Comm) 244 at [54].

¹⁹ R Merkin, “Reforming insurance law: is there a case for reverse transportation?” Report for the English and Scottish Law Commissions on the Australian experience of insurance law reform (2007), p 12.

Good faith as a shield: the implications for our proposals

- 3.16 In Issues Paper 6, we considered whether the law should be reformed to provide policyholders with a claim for damages against an insurer who acted in bad faith. As we discuss in Part 4, many consultees expressed concern about such a development. They feared that, however limited the right initially, it would soon develop along the lines of the doctrine of good faith in the United States, with substantial damages being awarded against insurers.²⁰ Their preference was for the issue to be dealt with under normal contract principles: the insurers' obligation should be re-characterised as a duty to pay valid claims within a reasonable time, subject to the terms of the contract.
- 3.17 Consultees were divided over whether the insurer should be entitled to exclude or limit its liability for damages for late payment by inserting a term into the contract. In Part 5, we propose that in business insurance an exclusion term of this type should generally be valid, but should be subject to the insurer's duty of good faith. In other words, an insurer should only be entitled to rely on a contract term to exclude or limit its duty to pay claims if it can show that its decision to delay or refuse payment was made in good faith.
- 3.18 This approach sees good faith as a shield: the doctrine would be used to protect policyholders against an insurer who attempts to hide behind an exclusion clause to act in bad faith. It would not be a sword to enable a stand-alone action. We think this approach accords with the way that good faith is developing in both the English and Scottish courts.

DAMAGES FOR THE INSURER'S BREACH OF STATUTORY DUTY

- 3.19 The FSA provides detailed rules on claims handling by insurers, set out in the Insurance Conduct of Business Sourcebook (ICOBS). Rule 8.1.1 requires insurers to:
- (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.
- 3.20 Breaches of the FSA Rules have two possible consequences. Firstly, the FSA may take disciplinary action against the insurer in its regulatory capacity, such as imposing a fine or publishing a statement of the insurer's misconduct.²¹ This is unlikely to help an individual policyholder who has suffered loss.
- 3.21 Secondly, a policyholder may bring a claim for damages under section 150(1) of the Financial Services and Markets Act 2000. This states that:

²⁰ We discuss the position in the United States in our Issues Paper - Insurance Contract Law Issues Paper 6: Damages for Late Payment and the Insurer's Duty of Good Faith (March 2010) paras A.41 to A.69.

²¹ Financial Services and Markets Act 2000, s 66.

A contravention by an authorised person of a rule is actionable at the suit of a private person who suffers loss as a result of the contravention, subject to the defences and other incidents applying to actions for breach of statutory duty.

The limits of section 150

3.22 A claim for damages under section 150(1) may be useful, but it is very rarely used in practice.²² A claimant must establish that there has been a contravention of an FSA rule and that, as a result, a loss has been suffered.²³ Most problematically, redress under section 150 is only available to “a private person”. This concept appears to envisage two broad categories of claimant:

- (1) *An individual.* This includes both a consumer who is not acting in the course of business, and a sole trader who is acting in the course of business.²⁴
- (2) *A legal person, such as a company or corporate body (including partnerships) which is not acting in the course of business.* The definition of a “private person” is expanded by the Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001. Regulation 3(b) states that “private person” includes:

Any person who is not an individual, unless he suffers the loss in question in the course of carrying on business of any kind.

3.23 This second category is restricted because the definition of “business” has been interpreted expansively. In *Titan Steel Wheels v RBS*,²⁵ Titan bought currency swap and derivative products from a bank to hedge against exchange rates fluctuations. When this led to losses, Titan sought to rely on section 150 to bring a claim, arguing that the phrase “carrying on business of any kind” should be interpreted only to exclude claims by professional investors. Titan argued that their business was making wheels, not investment.

²² Insurance Contract Law Issues Paper 6: Damages for Late Payment and the Insurer’s Duty of Good Faith (March 2010), para 5.18.

²³ See, for example, *R (BBA) v Financial Services Authority and Financial Ombudsman Service* [2011] EWHC 999 (Admin), [2011] 18 LS Gaz R 20, by Ouseley J at [71].

²⁴ Under this category, those losses cannot have been sustained in the course of carrying on any regulated activity under the FSA definition: Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001 (SI 2001 No 2256), reg 3.

²⁵ *Titan Steel Wheels Limited v The Royal Bank of Scotland plc* [2010] EWHC 211 (Comm), [2010] 2 Lloyd’s Rep 92.

- 3.24 This argument was rejected. Instead, the court gave a wide meaning to the phrase “carrying on business of any kind”, which included a wider variety of business activities than Titan normally carried out. This is in line with recent banking law decisions in which the courts have prevented aggrieved companies from obtaining private redress for loss-making financial products.²⁶ Indeed, it is difficult to think of examples other than charitable company activities which would fall outside of the wide construction of “carrying on business” under *Titan Wheels*.
- 3.25 It is not surprising that section 150 has been so little used. Most consumers and small businesses will find it easier to complain to the FOS than bring a complex, novel action before the courts for breach of statutory duty. Most other businesses are excluded because they are companies and suffer losses in the course of business. As we have seen, many of the cases we are concerned with involve small companies which have lost profits following catastrophic events, such as fires. These policyholders are not entitled to use section 150.
- 3.26 We think that as currently drafted, section 150 has limited potential to provide redress to claimants. A respondent to our Issues Paper suggested that one way forward may be to extend the operation of section 150, to provide a greater range of claimants with an action for damages for breach of ICOBS 8.²⁷ Although this may be a possible approach, we do not think it undermines the case for removing an unprincipled and anomalous provision of English contract law. For these reasons and taking into account the current Scots law position, we believe the need for statutory reform to reverse *Sprung* is not diminished by the availability of section 150.

THE FINANCIAL OMBUDSMAN SERVICE

- 3.27 The FOS regularly deals with complaints about delayed payment and bad claims handling. It hears complaints from both consumers and “micro-enterprises” (defined as those with less than 10 staff and an annual turnover of under 2 million euros).²⁸ Importantly, the FOS decides disputes “by reference to what is [in the opinion of the ombudsman] fair and reasonable in all the circumstances of the case”.²⁹ In considering what is fair and reasonable the ombudsman may take into account: relevant law and regulations; regulators’ rules, guidance and standards; codes of practice and industry practice.

²⁶ See, for example, *Peekay International Ltd v ANZ Banking Group Ltd* [2006] EWCA Civ 386, [2006] 2 Lloyd’s Rep; *Springwell Navigation Corp v JP Morgan Chase Bank* [2010] EWCA Civ 1221, [2010] 2 CLC 705; *Cassa di Risparmio della Repubblica di San Marino SpA v Barclays Bank Ltd* [2011] EWHC 484 (Comm).

²⁷ We are indebted to Mr Jonathan Goodliffe for providing helpful information on this point. For further discussion, see Jonathan Goodliffe, *British Insurance Law Association Journal* November 2011, No.123, *Late payment of insurance claims: a legal or regulatory issue?*

²⁸ The definition is found in the FSA Handbook, DISP 3.6.1. This is in line with the EU Payment Services Directive 2007/64/EC.

²⁹ Financial Services and Markets Act 2000, s 228(2).

- 3.28 We have already explained in Part 2 that the FOS awards damages for distress and inconvenience to consumers. In business contracts, we have been told that the FOS does not apply the rule in *Sprung*: ombudsmen are prepared to award damages for financial loss and inconvenience suffered by a business. Our analysis of six sample FOS cases suggests that the FOS requires claimants to prove their losses to a high standard. Nevertheless, some large awards have been made: one case in our sample saw an award of £100,000, the maximum amount the FOS may award.
- 3.29 We are told that the insurance industry appears to accept the approach taken by the FOS. Insurers seem willing to pay damages for clearly proven losses to these small businesses.

Limits of the FOS

- 3.30 The FOS approach is a legitimate exercise of its power to resolve disputes with reference to accepted industry standards and depart from the strict requirements of the law. It plays an important role in assuaging the harshness of the law in this area. We think, however, that it is unfortunate to have a law that is so far from the accepted standard of fairness that ombudsmen routinely ignore it. If the ombudsmen are resolving disputes in a manner which departs from the law and the insurance industry appears to accept it, this divergence presents an inherent need to review the law.
- 3.31 Moreover, the nature of the FOS jurisdiction prevents resolution of disputes for any businesses which have more than 10 staff or a turnover of over 2 million euros. Small and medium sized businesses above this threshold will still suffer the full force of the law. Yet, in our view, it is often those small and medium businesses that fall just outside of the FOS jurisdiction which would suffer most dramatically from the rule in *Sprung*. Such businesses may rely heavily on prompt, sufficient payment of insurance monies after suffering a loss. The law, if unchanged, remains an unmitigated and unfair burden on such businesses.

CONCLUSION

- 3.32 We have seen that although insurers owe policyholders a duty to act in good faith, this does not provide the policyholder with a right to damages where the duty is breached. A private person may be entitled to bring a claim for breach of statutory duty if an insurer fails to handle a claim properly and fairly. This, however, is a complex action for consumers or sole traders to use, and it does not protect incorporated businesses. We do not consider it to be a substitute for reversing the rule in *Sprung*, discussed in Part 2.
- 3.33 Consumers and micro-enterprises are entitled to complain to the FOS, and the FOS is prepared to award damages against an insurer who fails to pay a valid claim within a reasonable time. This may include limited damages for distress and inconvenience in appropriate cases. Previously we have argued that if the law is unfair and out of line with accepted industry practice, as applied by the FOS, then the law should be changed. As we discuss in Part 4, we think that there is a strong case for reform of the law in this area.

PART 4

DAMAGES FOR LATE PAYMENT: THE CASE FOR REFORM

- 4.1 In Part 2, we explained that English law does not award damages to policyholders who have suffered loss through an insurer's failure to pay a valid claim within a reasonable time. The English treatment of insurance contracts is out of step with ordinary contract principles. The case of *Sprung v Royal Insurance (UK) Ltd*¹ held that an insurer's primary obligation is not to pay valid claims but to "hold the insured harmless". An insurer's breach of contract occurs when the harm occurs, and the insurance payment is characterised as damages for that breach. Accordingly, damages are not payable for a failure to pay damages.²
- 4.2 In March 2010,³ we argued that the law in this area should be reformed and asked for views. The responses we received indicated widespread support for reform and have confirmed our view that legislative reform is needed.⁴
- 4.3 In this Part we start with the arguments in favour of reform. We then note that some industry bodies urged caution. The responses revealed three controversial areas: the role of exclusion clauses; the role of good faith; and the definition of "a reasonable time". We discuss these in more detail below.

THE CASE FOR REFORM

- 4.4 Out of the 32 responses we received, all but one agreed that the law in this area should be reformed. It is noteworthy that all 12 of the insurers and insurance associations who responded thought there should be some change to the current law. As the Association of British Insurers (ABI) put it:
- The ABI accepts that there is a need for reform in this area If the insurer has declined a valid claim and has acted unreasonably, we accept that the law should be brought into line with general commercial contractual principles.
- 4.5 The current law was thought to be unprincipled and unfair, and risked bringing English law into disrepute.

¹ [1999] 1 Lloyd's Rep IR 111.

² *The President of India v Lips Maritime Corporation (The Lips)* [1988] AC 395.

³ Insurance Contract Law Issues Paper 6: Damages for Late Payment and the Insurer's Duty of Good Faith (March 2010).

⁴ We provide only an overview of the responses here. For a more detailed summary, see Insurance Contract Law, Summary of Responses to Issues Paper 6: Damages for Late Payment and the Insurer's Duty of Good Faith (March 2010).

The law is unprincipled

- 4.6 The idea that an insurer was under an obligation to hold an insured harmless was described by Geoffrey Lloyd and Derrick Cole as “an arcane and wholly indefensible concept”. They also commented:

We find the concept of the insurer being expected, as far as legal principles are concerned, to hold the insured harmless a bizarre concept. Many experienced insurance men and women would be as astonished as we were when we discovered this to be the case.

- 4.7 The Scottish approach was thought to be more principled. In Scots law the insurer’s obligation is to pay valid claims within a reasonable time. An insurer who breaches this obligation is liable to pay damages for the insured’s proven and foreseeable loss.

The law is unfair

- 4.8 Several responses argued that the rule in English law has led to unfairness. For a policy of insurance to be effective, payment must be made within a reasonable time. As the British Insurance Brokers’ Association (BIBA) put it:

Consumers buy insurance to protect their possessions and businesses buy to protect their assets and liabilities. Any delay in payment can negate that protection.

- 4.9 Where businesses suffer from fires or floods, timely payment is often crucial to their survival. This is true for both large and small businesses. Airmic, who represent insurance buyers for around three-quarters of FTSE 100 companies, commented:

Effective indemnity depends as much on the timing of payments as the adequacy of the final settlement if a business is to survive the post loss recovery period. In the event of unreasonable delays in the settlement process, there is currently inadequate opportunity for legal redress. This fact does nothing to encourage reasonable behaviour on the part of the insurer.

- 4.10 We were told that the issue of timely payments has become more acute as firms find it more difficult to obtain bridging loans from banks in the current economic climate.

The rule affects the fairness and competitiveness of English law

- 4.11 The General Council of the Bar argued that English law was not perceived as fair internationally:

We are regularly instructed in cases where clients find it remarkable that they cannot seek damages for loss to their businesses occasioned by insurers unreasonably refusing to pay insurance claims or delaying such payments.

- 4.12 In an international legal market, this perceived unfairness could affect the attractiveness of English law. Covington & Burling, an international law firm representing corporate policyholders, argued that the current rules have rendered English law uncompetitive:

Those of our clients that have experience of both US and English Law justifiably regard English law, as it currently stands, as being excessively insurer-friendly, and therefore seek to agree, or argue for, the application of systems of law other than English law and to seek alternative fora for their disputes, other than the courts of England and Wales or London arbitration.

- 4.13 Airmic also compared English law unfavourably with other jurisdictions:

Many Airmic members operate in multiple territories throughout the world as well as the component parts of the UK. In almost all of these territories, they will be competing with local business that benefit from a more favourable legal framework.

Conclusion: the need for statutory reform

- 4.14 Following the responses we received, we are persuaded that there is a compelling case for reform. The British Insurance Law Association (BILA) described the decision in *Sprung* as “the principal defect in this part of English insurance law, requiring remediation as soon as possible”.

- 4.15 Most consultees argued that change should not be left to the courts. This would be time-consuming and require a case to be taken to the Supreme Court. As the General Council of the Bar commented:

We are strongly in favour of *Sprung* being reversed. Attempts have been made to do so through the courts but this has not been achieved. Our experience is that those who would wish to challenge *Sprung* do not usually have the financial means to pursue this through the appellate courts.

- 4.16 The majority of consultees supported legislative intervention to re-characterise the insurer’s obligation as a duty to pay a valid claim within a reasonable time. If the insurer breached this obligation it would give rise to damages for proven and foreseeable loss, according to the normal principles of contract law. In Part 5, we propose legislative reform along these lines.

THE NEED FOR CAUTION

- 4.17 That said, several industry organisations argued in favour of a cautious approach. They stressed two issues.

- 4.18 First, a change in the law should not prevent insurers from investigating claims fully. As the Forum of Insurance Lawyers (FOIL) put it:

It is essential that the rules concerning claims must allow insurers to properly investigate claims, and be in a position to challenge claims which they believe to be unfounded within a fair framework. There is a danger that the introduction of a claim for consequential loss in addition to the risks covered by the policy may make it very difficult for insurers to challenge claims, or repudiate liability for fear of disproportionate economic consequences if their decision were later found to be incorrect.

- 4.19 Secondly, insurers pointed out that the amount of a policyholder's loss may be disproportionate to the size of the claim. It was said, for example, that a typical mortgage payment protection claim might be in the order of £10,000. The consequences for a policyholder for failing to meet their mortgage commitments, however, might run into "hundreds of thousands of pounds". Thus liability for foreseeable loss could become unpredictable and disproportionate. The ABI were concerned that this would make it more difficult to reserve claims:

We are also concerned that there is the possibility for exposure to go beyond policy limits, for example if a claim arises from a business which due to a delay in payment has become bankrupt. These proposals therefore have implications for insurer's reserving and reinsurance arrangements.

- 4.20 Others noted that detailed reserve and capital processes placed on insurers by the Financial Services Authority (FSA) meant that it was essential for firms to assess their contingent liabilities properly.
- 4.21 We have borne these concerns in mind whilst developing our proposals.

AREAS OF CONTROVERSY

- 4.22 The responses to Issues Paper 6 highlighted three controversial areas, which we address below. The questions are:
- (1) How far should the insurer be entitled to exclude or limit its liability to pay damages for late payment?
 - (2) Should liability depend on whether the insurer has acted in good faith or bad faith?
 - (3) How does one define a "reasonable time" for payment?
- 4.23 The answers to questions (1) and (2) are linked. In the Issues Paper, we suggested that an insurer should be entitled to exclude its general contractual liability to pay damages, but should not be entitled to exclude its obligation to act in good faith.

The role of exclusion clauses

- 4.24 In Issues Paper 6, we noted that for consumer insurance any exclusion clause would need to be fair within the meaning of the Unfair Terms in Consumer Contracts Regulations 1999 (UTCCR). We thought it unlikely that the Financial Ombudsman Service (FOS) or the courts would consider a clause excluding liability for late payment to be fair.

4.25 For business insurance contracts however, we tentatively proposed that the parties should be able to agree to exclude the insurer's liability for damages for late payment. Thus liability to pay would be subject to an express contract term. We asked if consultees agreed.

4.26 Consultees were fairly evenly divided on this issue. On one side of the argument, it was pointed out that insurance contracts often reflect unequal bargaining power. Thus an exclusion clause may reflect the power of the insurer rather than a genuinely free bargain. BIBA told us:

The bargaining strengths of the respective parties within an insurance contract are not equal. Only a very limited number of very large companies would have an exclusion applied or be in an equal position to negotiate the removal of this term.

4.27 Covington & Burling echoed this point:

Even large corporate policyholders cannot be said to have equality of bargaining power with commercial insurers, who invariably display little flexibility in contract negotiations relating to basic policy terms other than premium or deductibles.

4.28 Professor John Birds emphasised that small businesses in particular should be protected:

I do not see why, whatever its legal form, a genuinely small business, or at least one that buys direct and not through an intermediary, should not be fully protected.

4.29 By contrast, industry bodies and insurers mostly supported the ability to exclude the duty in business insurance contracts. This would be in accordance with the normal rules of contract, based on the principle of freedom of contract. The City of London Law Society argued that "parties should be free to contract as they see fit".

4.30 Insurers were particularly keen on the ability to limit damages, to ensure that the amount did not exceed policy limits or was not disproportionate to the size of the claim. The Lloyd's Markets Association (LMA) argued that if *Sprung* were to be reversed, this would need to be balanced by some "control mechanisms" on consequential loss to provide certainty for insurers.

The role of good faith

4.31 In Issues Paper 6, we drew a distinction between insurers who fail to pay honestly, for a good reason, and those who delay payment or decline claims in bad faith.

4.32 We provided an illustration of the difference:

At one end of the spectrum an insurer may refuse a claim because it genuinely believes that the loss falls outside the policy wording. It may receive legal advice to this effect, and may even win at first instance, only to be proved wrong by the Court of Appeal. Here the

insurer had an honest and reasonable (though mistaken) view that the claim was not valid.

By contrast, a claims manager may know a claim to be valid, but deliberately delay payment beyond the end of the year simply to obtain a bonus. Here the delay is neither honest nor reasonable, but is made in bad faith.

4.33 In the Issues Paper, we discussed two separate bases for liability. The first basis would be for failing to pay a valid claim within a reasonable time. This liability would be “strict” in that it would not depend on the fault of the insurer. It could, however, be excluded by a contract term.

4.34 The second liability would be for breach of the duty of good faith. This would only apply where the insurer acted dishonestly, or so unreasonably that no reputable insurer could act in that way. We argued that an insurer should not be entitled to exclude its duty to act in good faith. As we put it in the Issues Paper:

We think this would be inimical to the nature of an insurance contract. Nor do we think such a clause would represent a genuinely negotiated bargain. No policyholder who properly considered the matter would agree that the insurer could refuse a claim in a biased or unfair way, or without properly investigating the claim. We note too that in Australia the duty of good faith cannot be excluded.

4.35 These proposals brought a mixed response. Some welcomed the idea that insurers should be liable to pay damages if they breached their duty of good faith. It was thought that this would discipline the market and help boost market confidence. As Mr Barrie Jervis wrote:

As a claims settler and compliance officer of 40 years experience ... for various Lloyd’s syndicates, I am well aware that some insurers deliberately delay payment of claims I have anecdotal evidence that some insurers ... operating in the UK give their claims department a budget for claims payments for each month. This may be the reason why some insurers delay payment – so as to balance their claims budgets.

4.36 Many consultees agreed that the duty of good faith should be non-excludable. As Ms Janan Al-Asady argued:

The fundamental importance of the duty of good faith would be circumvented if insurers were permitted to exclude it in their contracts. Therefore the statutory duty of good faith must be mandatory.

4.37 Some insurers agreed that there ought to be a non-excludable duty of good faith. As RBS Insurance noted:

We agree that an insurer should not be permitted to exclude its statutory duty of good faith.

4.38 Ten respondents, however, argued against introducing damages for breach of the duty of good faith. We proposed that damages would be limited and controlled; only foreseeable losses would be recoverable according to normal contract rules. Respondents feared, however, that any change would soon develop into a tort/delict of bad faith, opening the possibility of punitive damages against insurers.

4.39 In Canada and the USA, the courts have been prepared to provide high levels of tort damages against insurers.⁵ Respondents feared that our proposals would mark the first step towards the same result. As Beachcrofts put it:

The proposed approach would mark the introduction of "bad faith" into insurance contracts. Whilst the proposals are a long way from the current position in the US, the floodgates could then open here, with damages straying from compensatory to penal and being used to force insurers to pay claims where there is no liability.

4.40 We have been persuaded that damages for bad faith would be a step too far, with unpredictable consequences. As we discuss in Part 5, we think it would be better to view the duty of good faith as a shield rather than a sword. We propose that it should not be a standalone action, giving rise to damages. Rather, it should be used to prevent an insurer from using an exclusion clause to hide from the consequences of its own bad faith.

4.41 We do not think insurers should be entitled to exclude liability for breaches of contract where those breaches are made in bad faith. Thus, before an insurer could rely on a clause limiting or excluding its obligation to pay valid claims within a reasonable time, it would need to show why the decision took so long, or why it refused to pay a claim which was later found to be valid. If the decision was one which no reputable insurer could have reasonably taken on the information available to it at the time, then the insurer should not be entitled to rely on the clause.

Payment within a reasonable time

4.42 Most consultees agreed that the insurer's duty was to pay valid claims within a reasonable time. There was some controversy, however, over how "a reasonable time" should be defined.

4.43 Insurance policies are diverse and can operate under dramatically different circumstances. Thus Swiss Re told us that "a reasonable time" might differ considerably from case to case:

Whilst it may be easy to determine whether a claim is valid in some instances (for example property), even if the quantum is unclear, this is not the case across the board. For example, catastrophe and liability can often take years to properly establish validity, even when

⁵ Insurance Contract Law Issues Paper 6: Damages for Late Payment and the Insurer's Duty of Good Faith (March 2010), paras 7.11 to 7.14. Also see *Whiten v Pilot Insurance Company* [2002] 1 SCR 595, in which the Supreme Court of Canada upheld an award of \$1 million in punitive damages.

the insurer is acting in good faith and following best practice. Claims must be properly investigated and issues in commercial cases are often hugely complex.

- 4.44 Ince and Co pointed out that the concept may be “class sensitive” (storm damage may take less time to investigate than a motor accident) and “location sensitive” (an accident in the UK may be more expedient to investigate than an accident in, say, China). Moreover, some policyholders may supply information more quickly than others.
- 4.45 This led some consultees to argue that it should be left to the courts to consider whether a delay has been reasonable. Other consultees, however, emphasised the need for certainty about the boundaries of a “reasonable” period.

A reasonable time to “assess a claim”

- 4.46 The question of defining a “reasonable” period of time is a complex one. It is important that limiting the amount of time which an insurer has to determine a claim does not impact upon its ability to challenge it. If an insurer receives a suspicious or fraudulent claim, it should be entitled to investigate it adequately even if such an investigation risks some delay in payment. Furthermore, where delay is caused by the insured (for example, where the insured fails to provide necessary information to the insurer), insurers should not be penalised.
- 4.47 One solution suggested by consultees was to separate the period of time over which an insurer investigates a claim, and the period over which the insurer considers it. In the former period, the insurer has the opportunity to exercise its legitimate right to fully investigate the claim and obtain all the information it requires to arrive at a decision on the claim. Once the insurer has all the information, it must then arrive at and communicate its decision promptly. This would be in line with Scots case law.⁶ As RGA Reinsurance suggested:

The law should be clear ... that an insurer can only begin to properly assess a claim once it has all the relevant information. In the US, many of the laws in the area state the time within which a claim must be paid beginning upon receipt of a “clean claim”, meaning that the clock does not begin ticking, so to speak, until the insurer is in possession of all the information necessary to assess the claim. Often, an insurer is dependent upon third parties, as well as the claimant him or herself, to provide certain information and therefore has no control over the period of time it takes to fully assess the claim.

- 4.48 The International Underwriting Association (IUA) held a similar view:

Any potential remedy should only be triggered after the insurer has had an opportunity to review and adjust the claim, not from the point of loss.

⁶ See *Strachan v The Scottish Boatowners’ Mutual Insurance Association* 2010 SC 367.

- 4.49 We agree with this suggestion. Claims can be extremely complex, and an insurer is entitled to investigate thoroughly. Once the insurer has all the necessary information, however, the insured is entitled to a prompt decision.

CONCLUSION

- 4.50 We think there is a strong case for legislation to reverse the decision in *Sprung* and to re-characterise an insurer's contractual obligation as the duty to pay valid claims within a reasonable time.
- 4.51 We accept, however, that this obligation would only arise when the policyholder has provided the insurer with all necessary information. Thereafter an insurer should have sufficient time to carry out a full investigation, including seeking information from third parties.
- 4.52 We also accept that insurers need to be able to reserve claims and calculate the full extent of their exposure. In business policies, there will be commercial reasons why insurers would seek to limit damages for late payment through contract terms. They may, for example, wish to place a cap on damages to the extent of the policy limit or limit damages to a proportion of the claim. In some cases, insurers may wish to exclude liability altogether, though there may be resistance to this from policyholders.
- 4.53 On the other hand, we think that insurers should not be entitled to rely on exclusion clauses where they have deliberately refused to investigate a claim, or rejected a claim they know to be valid. In Part 5, we propose that before an insurer may rely on a clause which excludes or limits its liability for damages for late payment, it should provide a reason for its actions. If the decision was one which no reputable insurer could have taken, then the insurer should not be entitled to rely on the clause.

PART 5

DAMAGES FOR LATE PAYMENT: PROPOSALS FOR REFORM

- 5.1 In our view, the law on damages for late payment in England and Wales is in need of reform. In this Part, we set out our proposals for reform and invite views on them.
- 5.2 Our main proposal is to re-characterise the insurer's primary obligation as a duty not to prevent loss but to pay valid claims after a reasonable time. An insurer who unreasonably delays or wrongfully repudiates a claim would be in breach of this duty and liable to pay damages for proven and foreseeable losses. We then explain how a reasonable time would be defined as including sufficient time for full investigation and assessment of the claim. In business insurance an insurer would be entitled to exclude this liability through a contract terms. It could, however, rely on such an exclusion clause only if it had acted in good faith.
- 5.3 We also invite views on when the statutory limitation period in English law should begin, and on whether there should be statutory reform of the law on damages for distress and inconvenience.
- 5.4 Although our main proposals for reform follow the current Scots law, we think that any legislation implementing those proposals should apply to Scotland too, given the lack of judicial decisions at the highest level in that jurisdiction.¹ We must be careful to ensure, however, that such legislation does not deprive Scottish insureds of any rights which they have at present. We see no need to amend the law of prescription in Scotland. Any change to the law of limitation would be confined to England and Wales.²

A STATUTORY DUTY TO PAY VALID CLAIMS

- 5.5 At present, this area of insurance law in England and Wales is out of step with the principles of ordinary contract law. Under general contract law, where one party breaches a contract, the innocent party may claim damages for the loss suffered.³ Damages are limited to those losses which were reasonably foreseeable and within the contemplation of both parties at the time that the contract was entered into. Furthermore, the innocent party is under a duty to mitigate their loss.
- 5.6 Following the case of *Sprung v Royal Insurance UK Ltd*, however, the payment of an insurance claim has been characterised not as a contractual obligation on the part of the insurer, but as damages for breach of the obligation to prevent harm.⁴ The result is that an insurer who unreasonably delays payment or wrongfully

¹ The recent Outer House decision in *Toremar v CGU Bonus Ltd* [2009] CSOH 78, discussed in Issues Paper No 6 at para 3.13, may illustrate some of the potential difficulties that can arise in this situation.

² See further below para 5.38 and following.

³ *Hadley v Baxendale* (1854) 156 ER 145.

⁴ *Sprung v Royal Insurance (UK) Ltd* [1999] 1 Lloyd's Rep IR 111. See also para 2.14 and following above.

repudiates a valid claim is not liable to pay for the consequences of that delay, however foreseeable the loss. This anachronism of English law is unprincipled. It also has unfair consequences for policyholders, who often rightly rely on prompt payment to survive the immediate aftermath of a catastrophic event.

5.7 In Issues Paper 6, we proposed that the rule in *Sprung* should be reversed and that the insurer's duty should be re-characterised as the duty to pay valid claims within a reasonable time. Where an insurer breached this duty, an insured would be entitled to damages for proven and foreseeable loss, under ordinary contract law principles. This would bring English law into line with the law in Scotland. We received strong support for this proposal in the responses to our Issues Paper.

5.8 We also considered whether legislative reform of this area of law would be appropriate, as it would be open to the Supreme Court to overturn the Court of Appeal in *Sprung*. Most consultees, however, told us that the change should not be left to the courts, as judicial reform would be time-consuming and require a case to be taken to the Supreme Court.

5.9 **Do consultees agree that legislative reform should provide that:**

- (1) insurers should be under a contractual obligation to pay valid claims within a reasonable time; and**
- (2) an insurer who fails to meet this obligation should be liable to pay damages for any foreseeable losses which result?**

The definition of a reasonable time

5.10 Insurers need enough time to investigate claims fully, and to challenge claims which they believe to be unfounded. Moreover, insurers can be dependent upon third parties, or the policyholder itself, to provide the information necessary to fully assess a claim. Insurers should not be penalised for delay caused by the behaviour of other parties.

5.11 This seems to be the approach taken in Scotland. Under Scots law, the insurer is not obliged to pay the insured until a claim is made. Even then, the insurer is not required to pay immediately, but first has an opportunity to investigate the claim. As we have seen, in *Strachan v The Scottish Boatowners' Mutual Insurance Association*, Lord Eassie accepted the insurer's argument that:

It was clear under Scots law that that point in time [when the insurer came under obligation to make payment] could not be said to be the moment of the casualty. Before an obligation to pay could crystallise there had to be first the making of a claim. The insurer then had to have an opportunity to investigate its soundness, the insurer's obligation being only to pay upon a valid claim.⁵

⁵ 2010 SC 367 at [36].

5.12 Respondents to our consultation suggested that the law should separate the time period over which an insurer investigates a claim, and the period over which the insurer assesses it. We agree. First the insurer should have time to fully investigate the claim. Secondly, it should have time to review and consider the claim.

5.13 When an insurer receives an incomplete claim from the insured, it is reasonable for the insurer to notify the insured of the additional information it needs before it can investigate the claim. Provided an insurer acts reasonably in doing this, we think that the insurer's time to investigate should only begin on the receipt of a "clean claim" from the insured, that is once the insured has provided all the material information requested in respect of that claim. The insurer should then have sufficient time to carry out a full investigation, including time to seek information from third parties. Once it has investigated, however, it should assess the claim and arrive at and communicate its decision promptly. Furthermore, the period of time that is reasonable for an insurer to investigate and consider a claim varies between claims, and should take into account market practice, the type of insurance and the size, complexity and location of the claim.

5.14 **Do consultees agree that:**

(1) provided the insurer has acted reasonably in asking the insured for information to enable it to investigate the claim, the time to investigate should only begin once the insured has provided the insurer with all the material information requested?

(2) the insurer should have sufficient time to carry out a full investigation, including time to seek information from third parties where necessary?

(3) once it has investigated, the insurer should assess the claim and arrive at and communicate its decision promptly?

(4) overall, the insurer should have a reasonable time to investigate and assess the claim, taking into account market practice, the type of insurance, and the size, location and complexity of the claim?

Business insurance: an excludable duty

5.15 In our view, freedom of contract in commercial contracts should be preserved where possible. In business insurance, an insurer should be able to limit or exclude its liability to pay damages, provided that the insurer has made an honest error in good faith. We think that there may be good commercial reasons to limit damages for late payment, to enable insurers to reserve claims and put the necessary reinsurance provisions in place. We think that policyholders will be less likely to agree to a total exclusion of liability, but some policyholders may be willing to do so, in exchange for a suitable reduction in premium.

5.16 On the other hand, we do not think that insurers should be able to exclude liability for losses brought about by their own bad faith. No policyholder who is properly advised would agree to allow an insurer to delay or reject a claim in bad faith. Such an exclusion would be inimical to the nature of an insurance contract.

5.17 In Issues Paper 6, we suggested that an insurer who rejects a claim in bad faith would be subjected to two concurrent liabilities: the first for failing to pay a valid claim within a reasonable time, and the second for breach of the duty of good faith. We are no longer proposing to enact a new and distinct cause of action to provide damages for bad faith. Instead, we propose that the doctrine of good faith should act as a “shield”. We think this accords with recent legal developments, in which the duty of good faith is seen as a standard which informs the extent to which an insurer may rely on its legal rights.⁶

5.18 As we discuss below, an insurer would be prevented from relying on a clause which limits or excludes liability for delaying or rejecting a valid claim if it has not acted in good faith.

5.19 **Do consultees agree that in business insurance:**

(1) insurers should be able to limit or exclude their liability to pay damages for late payment through a term of the contract? and

(2) the term should only apply if the insurer has acted in good faith?

Consumer insurance: a non-excludable duty

5.20 In Issues Paper 6, we explained that we did not think that clauses which excluded the insurer’s liability to pay damages were appropriate for consumer insurance.

5.21 The current legal position is that in consumer insurance, an insurer may only rely on an exclusion clause if it is fair within the meaning of the Unfair Terms in Consumer Contracts Regulations 1999 (UTCCR). We think that, if challenged, it is questionable whether an exclusion to absolve an insurer from liability for damages for late payment would be upheld by the courts. We also think it unlikely that the Financial Ombudsman Service (FOS) would uphold such an exclusion.

5.22 From a regulatory perspective, such an exclusion of liability may also be considered an unfair term. The fairness of terms in consumer contracts is an important element of the Financial Services Authority (FSA) principles on Treating Customers Fairly. In our view, such exclusions would also be subject to regulatory scrutiny.

5.23 Given this, we believe that to refrain from prohibiting such exclusions outright would be illogical. If such exclusions were permitted, consumers are unlikely to have adequate bargaining power to negotiate for their removal. Additionally, though it would be open to consumers to challenge the fairness of the exclusion under UTCCR, this would require the policyholder to undertake the costly task of taking the insurer through the courts. As we are of the view that the FOS would be unlikely to uphold such exclusions in any case, we aim to avoid introducing further divergence in legislation and regulatory practice through our reforms. We would therefore propose prohibiting such exclusions in law.

⁶ See, for example, *Fagnoli v GA Bonus Plc* [1997] CLC 653, by Lord Penrose at 670 to 671.

5.24 The draft Consumer Insurance (Disclosure and Representations) Bill, introduced into the House of Lords in May 2011, includes a specific clause to prevent insurers from contracting out of the provisions of the Bill. Clause 10(1) renders a clause of no effect if it purports to put the consumer in a worse position than the Bill provides. The new legislation could include a similar clause.

5.25 **Do consultees agree that in consumer insurance, insurers should not be able to limit or exclude their liability to pay damages for late payment?**

A “SHIELD” OF GOOD FAITH IN BUSINESS INSURANCE

5.26 We propose that a “shield” of good faith ought to protect policyholders from an insurer seeking to rely on an exclusion clause to avoid liability to pay damages for late payment.

5.27 The circumstances in which the shield applies would be where a court has found that the insurer failed to make a decision within a reasonable time, or wrongfully repudiated a valid claim. The insurer would normally be liable to pay the insured’s proven and foreseeable losses. The insurance policy may, however, contain an exclusion of such liability. Here, invoking the exclusion would be subject to the condition that the insurer has acted in good faith.

5.28 Where there has been unreasonable delay and the insurer seeks to rely on an exclusion of liability, we think that the insurer should be required to explain why it acted as it did. It would then be open to the courts to evaluate whether the decision was one which could have been taken by an insurer acting in good faith, given the circumstances and the information available at the time. The test is narrower than the question of whether an insurer made the wrong decision with regards to a claim. In such cases, we believe the risk of an insurer making a mistake is within the scope of the parties’ power to freely negotiate contracts and assign risk. For example, if an insurer makes a genuine mistake in deciding that a claim is outside the scope of a policy and there is a contractual exclusion in place, the insurer should be able to rely on this exclusion of liability.

5.29 On the other hand, the “shield” protects an insured where an insurer acts or makes a decision in a way that no insurer acting in good faith would have done in those circumstances. For example, if it is discovered that claims handlers delayed or rejected a claim they knew to be valid in order to secure a bonus payment or with a view to any internal budgets or quotas, and there is a contractual exclusion in place, the insurer should not be able to rely on this exclusion.

5.30 This is a high threshold. In order to defeat an otherwise valid exclusion, the courts would have to be satisfied that the insurer was not acting in good faith in the circumstances. The insurer is given a level of deference: it can use the exclusion clause where the decision was mistaken, but made honestly and on reasonable grounds. An insurer may rely on an exclusion where it considers the delay was caused by circumstances outside its control (for example, a serious flood which caused severe disruption to its office). If the delay was caused by this disruption, then the insurer could rely on the exclusion. It will depend on the circumstances of each case.

- 5.31 Our underlying reason for this element of the proposal is that freedom of contract should generally be preserved. Where an exclusion clause has been agreed to, then it is only under extreme circumstances that the clause should be defeated. Equally, such exclusion clauses should not provide insurers with unbridled discretion. The “shield” of good faith would operate as a backstop to protect insureds from insurers who delay or refuse payment of valid claims for unscrupulous reasons.
- 5.32 **Do consultees agree that an insurer should not be entitled to rely on an exclusion clause to limit liability for a delayed payment or a rejected claim where it has not acted in good faith?**
- 5.33 **Do consultees agree that where an insurer seeks to rely on an exclusion clause:**
- (1) **the insurer should explain to the insured why the payment was delayed or rejected; and**
 - (2) **the court should evaluate whether the insurer was acting in good faith, given the circumstances and the information available to it at the time?**

The test for good faith

- 5.34 In sum, we propose preserving good faith as a “shield” to protect insureds against the unfair operation of exclusion clauses. We are mindful, however, that this is an area of law where certainty is important to both insurer and policyholder. In our Issues Paper, we invited consultees’ views on a proposed set of non-exhaustive guidelines on the content of good faith in the claims handling process.
- 5.35 Most consultees told us that such guidelines were unobjectionable in themselves, and that they should remain non-exhaustive. We received mixed views however, as to whether guidelines were appropriate at all. Given the array of existing rules and guidance, several consultees thought that further legislative guidelines on claims handling would introduce ambiguity and give rise to conflict. In particular, consultees anticipated potential conflict with insurers’ statutory duties under FSA rules, particularly Rule 8 of the Insurance Conduct of Business Sourcebook (ICOBS).⁷ Insurers are also subject to obligations under the FSA Treating Customers Fairly principles and a wide range of Association of British Insurers’ (ABI) Codes of Practice and Guidance Notes. Insurers were concerned about the introduction of yet more guidelines with which they would be required to comply.

⁷ Rule 8.1.1 states that 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.

5.36 We are eager to avoid introducing unnecessary complexity and confusion. We have therefore decided not to recommend the introduction of statutory guidelines which may conflict with any existing or future regulations. We think this area is best dealt with by FSA rules and industry guidance, particularly as, when deciding what is reasonable, it is anticipated that the courts will look to such guidance.

5.37 **Do consultees agree that legislation should not include further guidance on good faith in claims handling?**

LIMITATION OF ACTIONS IN ENGLISH LAW

5.38 In English law, our proposals have implications for the time available to a policyholder to bring litigation against an insurer for failing to pay an insurance claim. Under the Limitation Act 1980, the victim of a breach of contract has six years from the date of the breach to commence litigation.⁸ At present, the breach is said to occur at the time of the loss. Under our proposals the breach will not occur until the claim has been made and the insurer has had a reasonable time to investigate and assess the claim.

5.39 This would change the current approach to limitation. It has implications for cases such as *Callaghan v Dominion Insurance Co.*⁹ Here, a fire occurred in 1989. The insurers avoided the policy in 1990 and the policyholder issued proceedings in 1996. The court found that time started to run from the fire in 1989, not from the insurer's decision in 1990. The logic of our proposal means that the time to bring an action for the failure to pay an insurance claim would not start until the insurer had a reasonable time to investigate and assess the claim.

5.40 We have considered three options to deal with this issue, as discussed below.

From time of loss

5.41 The first would be to preserve the existing rule that the limitation period begins at the time of the loss. This has the advantage of certainty: it is usually easy to identify when the fire or flood, for example, occurred. The City of London Law Society argued that time should run from the date of the loss as it is "a certain and known date".

5.42 We are concerned that this option lacks any principle or logic. It would involve a specific exception to the Limitation Act 1980 to say that the time for bringing an action for breach of an insurance contract starts to run from before the breach has taken place. The Law Commission has called for a consistent approach to limitation based on general principles, rather than an exception of this type.¹⁰

⁸ Limitation Act 1980, s 5.

⁹ [1997] 2 Lloyd's Rep 541.

¹⁰ See our report, Limitation of Actions (2001) Law Com No 270.

From time of breach

- 5.43 Our preference would be for the limitation period to begin from the point at which an insurer has had a reasonable time to investigate and assess the claim. It is a rational analysis which leaves the logic behind limitation periods intact. Time would run from the breach of contract, namely the failure to pay the claim. Under our proposed reforms, the insurer's duty to pay only crystallises after it has had a reasonable time to investigate and assess the claim.¹¹ The British Insurance Law Association (BILA) argued that "logic and consistency" should be favoured over "simplicity". We agree.

From time of decision

- 5.44 We have also considered an alternative option, that is time should start to run from when the insurer communicated its decision to the insured that the claim is accepted or rejected.
- 5.45 To illustrate this possible option, we set out the following scenario:

January 2011 – a loss occurs.

February 2011 – the insured submits a claim; the insurer acknowledges it, but asks for more information. This is provided by the insured.

April 2011 – following investigation, the insurer assesses the claim and writes to the insured denying liability.

May 2011 – the insured disputes the decision and provides even more information.

June 2011 – after an internal review, the insurer decides to accept liability and makes an offer which is not accepted by the insured.

July to November 2011 – negotiations over the amount of the loss continue, but fail to reach agreement.

December 2011 – the insurer writes formally with a letter headed "final decision", offering half of what the insured is asking for.

- 5.46 In this example, arguably the insured presented a "clean claim" in February which was rejected by the insurer. This was the first letter telling the insured whether the insurer rejected or accepted the claim. However, negotiations carried on until December 2011 when a final letter was sent by the insurer. The negotiations had by then moved on to the amount of the loss, not just liability. The question under this option is when would time start to run; April, December or another date? It is difficult to know for certain when the insurer's "decision" was communicated and the breach of contract occurred. In this example, the December letter was headed "final decision" but it may not be. Although at first glance this option could provide more certainty, in practice we are not convinced this is the case. We are concerned that the proposal is as uncertain as our suggestion in paragraph 5.43, but lacks logic and consistency with general contract principles.

¹¹ See paragraphs 2.84 and 2.85 above for the position in Scots law on prescription.

- 5.47 **Do consultees agree that the limitation period in England and Wales to sue an insurer for a claim, should commence only after an insurer has had a reasonable time to investigate and assess the claim?**
- 5.48 **Alternatively, should the limitation period in England and Wales commence:**
- (1) at the time of loss; or**
 - (2) at the time the insurer's decision about the claim was communicated to the insured? If so, please comment on when in the claim's process you think this should be.**

DAMAGES FOR DISTRESS AND INCONVENIENCE IN CONSUMER INSURANCE

- 5.49 In Part 2,¹² we explained that where an insurer has agreed to reinstatement, policyholders have been able to obtain damages for distress and inconvenience caused by bad or slow workmanship of those engaged by the insurer to carry out the reinstatement.¹³ The English courts, however, have held that where an insurer fails to respond to a valid claim promptly or at all, damages are not available.¹⁴
- 5.50 The FOS approach does not uphold a distinction between these scenarios. Instead, compensation for distress or inconvenience is awarded widely, although the amounts awarded tend to be low. In Issues Paper 6, we argued that FOS was correct in its approach: we asked consultees whether they agreed. All but one supported the FOS approach in consumer insurance contracts, even though it does not follow the law.
- 5.51 In our 2009 Report, *Consumer Insurance: Pre-Contract Disclosure and Misrepresentation*,¹⁵ we argued that if the law was so fundamentally unfair that the FOS was forced to ignore it, then the law should be changed. We said that it was undesirable to have major differences between decisions made by the courts and decisions made by the FOS for three compelling reasons. Firstly, not all consumers are able to ask the FOS to look at their claims; it cannot help those with claims over £100,000, or those who are also claiming against a third party, such as Mr and Mrs England were in *England v Guardian Insurance*.¹⁶ Secondly, differences between the law and the FOS create unnecessary confusion. Thirdly, unfair law imposes inappropriate roles on financial regulators, rendering them policymakers rather than arbitrators.
- 5.52 We think this is another area where the law should be changed, to reflect normal contractual principles and FOS practice. In general consumer law, where a service has been sold to provide peace of mind, damages for distress and

¹² See para 2.76 and following.

¹³ *AXA Insurance UK Plc v Cunningham Lindsey UK* [2007] EWHC 3023 (TCC).

¹⁴ *England v Guardian Insurance Ltd* [1999] 2 All ER (Comm) 481. See paragraphs 2.77 and 2.77 above for the possibility of a different approach in the Scottish courts.

¹⁵ (2009) Law Com No 319; Scot Law Com No 219.

¹⁶ [1999] 2 All ER (Comm) 481.

inconvenience would be available in appropriate cases. In our view, insurance is a product which is sold to provide peace of mind to the insured. Such damages may be particularly relevant, for example, where a consumer's home has been left in serious disrepair for a prolonged period or where there has been a delay in approving medical treatment.¹⁷ We note that it may already be possible for Scottish courts to award damages in such cases.

- 5.53 We asked for views as to whether this should be left to the courts and the development of case law, or whether statutory reform was needed. This drew a mixed response: nine consultees favoured statutory reform and 10 thought it could be left to the courts. The argument in favour of statutory reform was certainty. BIBA argued that the approach should be enshrined in statute so that "it is a right rather than a whim". On the other hand, case law would allow more flexibility, on a case by case basis. In Scotland, a specific legislative provision would remove any uncertainty about the concept of damages for distress and inconvenience in such circumstances.
- 5.54 We propose that damages for distress, inconvenience or discomfort should be made available to the consumer. We ask consultees whether statutory reform is the best way of achieving this.
- 5.55 **Do consultees agree that damages for distress and inconvenience or discomfort should be available for consumer insurance policies?**
- 5.56 **Should this be achieved through statutory reform?**

¹⁷ See *England v Guardian Insurance Ltd* [1999] 2 All ER (Comm) 481, by Judge Thornton QC at [74]: "[damages for distress and inconvenience] are not awarded for breach of commercial contracts such as policies of insurance. Insurance policies only provide cover for such a loss where the cover expressly extends to provision of peace of mind or freedom from distress of the insured".

CHAPTER 2

INSURERS' REMEDIES FOR FRAUD

PART 6

INSURERS' REMEDIES FOR FRAUD: THE CURRENT LAW

INTRODUCTION

- 6.1 Fraudulent insurance claims are a serious and expensive problem. The law needs to play a robust role in deterring fraud by imposing a clear penalty on those who act dishonestly. Unfortunately, the law on the effect of a fraudulent claim is convoluted and confused. Although it is well-established that a policyholder who fraudulently exaggerates an insurance claim forfeits the whole claim, there is considerable uncertainty about the effect of a fraud on other claims made under the policy.
- 6.2 In July 2010 we published Issues Paper 7, *The Insured's Post-Contract Duty of Good Faith*, which examined the law in this area and invited views. We have developed our proposals in the light of the responses we received. Our aim is to clarify the law by setting out clear, practical sanctions which will have a strong deterrent effect.

The structure of this section

- 6.3 This section is divided into four parts:
- (1) In this Part we provide an overview of the current law. We explain how the divergence between the common law and section 17 of the Marine Insurance Act 1906 has generated unnecessary disputes. A fuller account of the law is provided in Issues Paper 7.
 - (2) Next, in Part 7 we state the case for reform. We summarise the criticisms of the current law and the responses we received to the Issues Paper. There was general agreement that legislation was needed to clarify the insurer's remedies.
 - (3) In Part 8 we set out our proposals for reform. Our proposals reflect current court decisions that a fraudulent claim should be forfeited, but that the fraud should not affect previous valid claims made under a policy. Following the strong arguments put to us, however, we propose that a fraud should discharge an insurer from future liabilities. Thus an insurer would not be obliged to pay any claim which arises following a fraud, whether or not it has taken action to terminate the contract. We also propose a new, but limited, liability on fraudsters to pay for insurers' reasonable and legitimate costs in investigating fraudulent claims.
 - (4) In Part 9 we consider the specific problems of joint insurance and group insurance schemes. We look at whether there is a need to protect an innocent policyholder where another joint policyholder has committed fraud. We also consider the anomalous position which arises where a member commits fraud whilst being a member of a group scheme. It would appear that because members are not policyholders the normal deterrents do not apply to them. We propose to remedy this defect.

ISSUES NOT COVERED

- 6.4 We do not deal with the criminal law. In England and Wales, a policyholder who dishonestly makes a false representation with the intention of making a gain commits an offence under section 2 of the Fraud Act 2006.¹ In Scotland, the common law offence of fraud is committed by bringing about a practical result by means of a false pretence.² However, prosecutions for this type of fraud are rare. This means that the civil remedies play an important part in deterring fraud, and are the focus of this reform.
- 6.5 Nor do we consider the definition of fraud. In Issues Paper 7 we discussed fraud and suggested that fraud can be thought of as a range of behaviours. We also discussed the main cases and we noted that the exact definition of fraud is not always clear-cut; we think this arises from the nature of the issue. We therefore concluded that the definition of fraud was best left to the courts. Dishonesty is a malleable and evolving concept, and we did not wish to interfere with the flexibility which courts require to identify fraud. Most consultees (20 out of 24) agreed, and we are therefore not proposing change in this area.

THE NEED FOR DETERRENCE

- 6.6 Insurers are particularly vulnerable to fraud, as policyholders are often the only people fully aware of the circumstances of a loss. The evidence suggests that fraudulent claims are a significant problem. The Association of British Insurers (ABI) reports that in 2010 insurers uncovered 133,000 fraudulent claims. The value of these claims totalled £919 million or 5% of the value of all claims made on its members that year. Insurance fraud is said to cost the UK economy £2 billion every year.³
- 6.7 If a claim is made in the absence of a genuine loss, then clearly the insurer is not required to pay the claim. However, the law has long recognised that a fraudster should risk more than the non-payment of the fraudulent part of the claim. The point was put forcefully in 1866 in *Britton v Royal Insurance Co*:

It would be most dangerous to permit parties to practise such frauds, and then, notwithstanding their falsehood and fraud, to recover the real value of the goods consumed.⁴

¹ Under s 3, it is also an offence to dishonestly fail to disclose information which one is under a legal duty to disclose.

² The common law offence of attempted fraud is committed where the false pretence does not cause a practical result. See *The Laws of Scotland (Stair Memorial Encyclopaedia)*, Criminal Law (Reissue), para 364.

³ Association of British Insurers, News Release 31/11 (28 July 2011) available at http://www.abi.org.uk/Media/Releases/2011/07/You_could_not_make_it_up_but_some_did_Insurers_detecting_more_fraudulent_claims_than_ever_over_2500_worth_18_million_very_week.aspx

⁴ (1866) 4 F&F 905, at 909.

Forfeiting the claim

6.8 Since the nineteenth century, the courts have held that a person who fraudulently exaggerates a claim forfeits the whole claim. This does not depend on an express term of the contract, but is said to be a common law rule.⁵

6.9 An example of this principle is *Galloway v Guardian Royal Exchange (UK) Ltd*.⁶ Mr Galloway was burgled and suffered a genuine loss of around £16,000. When he submitted his claim, however, he fabricated a claim for a fictitious computer for around £2,000. The Court of Appeal rejected the whole claim, including the £16,000 of genuine loss. Lord Justice Millett noted:

There seems to be a widespread belief that insurance companies are fair game, and that defrauding them is not morally reprehensible. The rule which we are asked to enforce today may appear to some to be harsh, but it is in my opinion a necessary and salutary rule which deserves to be better known by the public.

6.10 We agree that it is important that fraudsters should face due sanctions. It is also important that, if the sanction is to have a deterrent effect, it is clear and well-known. As we discuss below, however, there are some unhelpful ambiguities in the law.

Section 17 of the Marine Insurance Act 1906

6.11 The central problem is the mismatch between the common law rule and the duty of good faith, as set out in section 17 of the 1906 Act. The section states:

A contract of marine insurance is a contract based upon the utmost good faith, and, if the utmost good faith be not observed by either party, the contract may be avoided by the other party.

6.12 The duty has been held to apply to all types of insurance.

6.13 Section 17 specifies only one remedy for failing to observe utmost good faith: avoidance of the contract. This means avoiding the contract from the start, that is, returning the parties to the position in which they would be had the contract never existed. In theory, insurers could require policyholders to repay all claims which had been paid under the policy, including genuine and legitimate claims finalised and paid before the fraud arose.

6.14 In practice, the courts have been reluctant to allow insurers to recoup valid claims which arise before the fraud took place. Finality is a core value of law in the UK: if a valid claim is paid under a valid contract, it seems wrong to attempt to overturn that payment on the basis of subsequent events.

⁵ For an analysis of the 19th century cases, see Lord Hobhouse, *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd and Others (The Star Sea)* [2001] UKLH 1, [2003] AC 469 at [62]-[67].

⁶ [1999] Lloyd's Rep IR 209.

- 6.15 The courts have sought to escape the conclusion that the remedy for fraudulent claims is avoidance of the contract, but at the cost of convoluted reasoning and uncertainty.
- 6.16 In the absence of an express term, the common law will apply. Below we start with a discussion on express terms and then consider the definition in common law.

EXPRESS TERMS

- 6.17 Many insurance policies include express terms setting out the consequences of fraud. The courts are usually willing to enforce such terms. Indeed, it has been held that since fraud clauses are common, there is no need to bring the clause to the insured's specific attention.⁷
- 6.18 An example in which a fraud clause was upheld is *Joseph Fielding Properties v Aviva Insurance*.⁸ The policy stated that in the event of fraud:

We will at our option avoid the policy from the inception of this insurance or from the date of the claim or alleged claim or avoid the claim.⁹

- 6.19 After a fire broke out on the insured's premises, JFP notified a claim to Aviva for over £2 million. Aviva sought to avoid on two grounds. Firstly, during the term of the current policy, JFP had made a previous fraudulent claim relating to drainage for nearly £10,000. Secondly, Aviva alleged that JFP had failed to disclose at inception that its principal shareholders had made fraudulent claims and misrepresentations to other insurers in the past.
- 6.20 The court concluded that each of Aviva's allegations were true. Aviva conceded that "if it could rely only upon fraud at common-law then it could not recoup the monies paid out"¹⁰ on previously genuine claims. However, Judge Waksman QC held that this point was "academic". It was not necessary to consider the common law position as the express fraudulent claims clause applied:

Whatever the common-law position might have been is irrelevant since Aviva has invoked an express condition of the policy whose meaning is clear – Aviva "may avoid the policy from inception".¹¹

⁷ *Nsubuga v Commercial Union Assurance* [1998] 2 Lloyd's Rep 682, at 686.

⁸ [2010] EWHC 2192, [2011] Lloyd's Rep IR 238.

⁹ Above, at [15].

¹⁰ Above, at [97].

¹¹ Above, at [96].

6.21 That said, the clause must be clear and unambiguous. In *Fagnoli v GA Bonus Plc*,¹² Lord Penrose held that the words “all benefit under the policy shall be forfeited” were ambiguous. They could apply to all benefit in respect of the claim, or all benefit in respect of the policy as a whole. He therefore applied the “*contra proferentem*” rule, which means that a clause should be construed against the party who puts it forward. On this basis, he decided that the words meant that only the claim to which the fraud related should be forfeited.

6.22 In consumer insurance contracts, a fraud clause would be subject to the Unfair Terms in Consumer Contracts Regulations 1999. Consumers would also have recourse to the Financial Ombudsman Service (FOS). The FOS has issued guidance on how it would deal with fraudulent claims, making clear that an insurer’s remedy is not avoidance but forfeiture:

The insurer is not obliged to pay the fraudulent claim and it can cancel the policy prospectively.¹³

6.23 This means that while a clause permitting an insurer to avoid the whole contract can apply in business insurance, it may be more difficult to apply such a clause against a consumer.

Excluding liability for fraud

6.24 In the unlikely event that an insurer agreed to a clause which excluded the policyholder’s liability for fraud, would this be valid? The courts have held that it would not be.¹⁴ There is, however, some doubt about whether it might be possible for a policyholder to exclude liability for fraud by their agent. In Issues Paper 7 we asked whether this should be clarified. As we discuss in Part 7, it was not thought to be a significant matter in practice.

WHERE THERE IS NO EXPRESS TERM: THE EVOLVING CASE-LAW

Early cases

6.25 Where there is no express term, the courts have struggled to provide a clear account of the appropriate remedy. Here we provide an overview of the main cases: a fuller account is provided in Issues Paper 7.

¹² 1997 SCLR 12; [1997] CLC 653; [1997] 6 Re LR 374.

¹³ *Ombudsman News*, Issue 21, October 2002.

¹⁴ *HIH Casualty & General Insurance v Chase Manhattan Bank* [2003] UKHL 6, [2003] 1 All ER (Comm) 349. In Scots law, parties may not, by virtue of contractual terms, exclude liability for fraud; see *Mair v Rio Grande Rubber Estates Ltd* 1913 SC (HL) 74, [1913] AC 853; *Boyd and Forrest v Glasgow and South Western Railway Co* 1915 SC (HL) 20, [1915] AC 526; and *H & JM Bennett (Potatoes) Ltd v Secretary of State for Scotland* 1988 SLT 390.

- 6.26 In 1994, the Court of Appeal held that the duty not to make a fraudulent claim was an implied term of an insurance contract.¹⁵ This view found support in some subsequent cases.¹⁶ It no longer appears to be good law, however, following the House of Lords decision in *The Star Sea*.¹⁷
- 6.27 Another line of cases has seen the insurer argue directly for a right of avoidance under section 17 of the 1906 Act. In *The Litsion Pride*,¹⁸ Mr Justice Hirst held that the duty of good faith applied post-contract and at a similar level to the pre-contract duty of good faith. Again, however, this was revisited in *The Star Sea* and can no longer be considered good law.

The Star Sea: reinterpreting the post-contract duty of good faith

- 6.28 In 2001, in *The Star Sea*,¹⁹ the House of Lords reinterpreted the post-contract duty of good faith, as set out in section 17 of the 1906 Act.
- 6.29 The case did not directly concern a fraudulent claim. Rather, the insurers argued that the insured had failed to disclose relevant material following a fire. The fire broke out in the ship's engine rooms. Attempts to extinguish it proved unsuccessful, partly because the engine room could not be sealed. Two vessels in the same fleet had suffered a similar fate, and the policyholder obtained a report into the circumstances. The insurers alleged that the policyholder had breached its duty of good faith by failing to disclose this report, which was relevant to the insurer's argument that the owners knew the ship to be unseaworthy.
- 6.30 The House of Lords limited the duty of good faith in two ways. First, the duty of good faith did not continue once legal proceedings had begun. Once a writ was issued, the parties' duties were governed by the rules of court procedure, which set out disclosure requirements and appropriate sanctions for non-compliance.
- 6.31 Secondly, the House of Lords distinguished between the pre-contract and post-contract duty of good faith. Whereas the duty to disclose information pre-contract was a strict one, after the contract the duty of good faith was flexible and varied according to context. As Lord Clyde put it:

¹⁵ *Orakpo v Barclays Insurance Services Co Ltd* [1994] CLC 373.

¹⁶ See, for example, *Royal Boskalis Westminster NV v Mountain* [1999] QB 674, [1997] LRLR 523, at 593 and 597; and *Continental Illinois National Bank v Alliance Assurance Co Ltd (The Captain Panagos D.P.)* [1986] 2 Lloyd's Rep 470, at 512.

¹⁷ *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd and Others (The Star Sea)* [2001] UKHL 1, [2003] AC 469.

¹⁸ See, for example, *Black King Shipping Corporation v Massie (The Litsion Pride)* [1985] 1 Lloyd's Rep 437.

¹⁹ *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd and Others (The Star Sea)* [2001] UKHL 1, [2003] 1 AC 469.

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.²⁰

6.32 Lord Scott noted that in the context of making a claim, all that was required was “a duty of honesty”.²¹ As Professor Clarke put it, “when a claim is made nothing short of fraud in the presentation of the claim will amount to a breach of the duty of disclosure and of good faith”.²²

6.33 This, however, leaves a question where the claimant does act fraudulently. If fraud is a breach of good faith, does section 17 give the insurer the right to avoid the contract? Lord Scott described this as “debateable” but refrained from deciding the point.²³

6.34 Lord Hobhouse severely criticised the remedy of avoidance. He thought that avoidance 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”. He explained:

The insurer is able not only to treat himself as discharged from further liability but can also undo all that has perfectly properly gone before. This cannot be reconciled with principle.²⁴

6.35 Lord Hobhouse noted that many traditional authorities did not use the language of avoidance, but referred to “forfeiture”. Accordingly, he suggested that based on the rule of law, the appropriate remedy for fraud was the forfeiture of the claim.

6.36 Subsequent cases have attempted to apply these principles. As we will see, this has not been an easy task.

The Mercandian Continent: limiting avoidance

6.37 In *The Mercandian Continent*,²⁵ Lord Justice Longmore reviewed the case law, noting that avoidance is not available for every case where the policyholder breaches the duty of good faith. He observed that:

It must have been intended by Parliament that avoidance by reason of post-contract matters should be subject at least to the same requirements as avoidance by reason of matters pre-contract.²⁶

²⁰ Above, at [7].

²¹ Above, at [111].

²² MA Clarke, *The Law of Insurance Contracts* (4th ed 2002), para 27-2B.

²³ *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd and Others (The Star Sea)* [2001] UKHL 1, [2003] 1 AC 469, at [110].

²⁴ Above, at [51].

²⁵ *K/S Merc-Scandia XXXXII v Certain Lloyd's Underwriters (The Mercandian Continent)* [2001] EWCA Civ 1275, [2001] 2 Lloyd's Rep 563.

- 6.38 The pre-contract remedy of avoidance is available under the common law only where the insurer has satisfied the tests for materiality and inducement as set out in *Pan Atlantic v Pine Top Insurance Co.*²⁷ Lord Justice Longmore attempted to adapt these two tests to the claims context, finding that the conduct which is relied on by the underwriters must be causally relevant to the underwriters' ultimate liability or, at least, to some defence that may be available to the underwriters.²⁸ Furthermore, the insured's conduct must amount to repudiation of the contract.²⁹
- 6.39 On the facts of the case, the insured's actions were held not to be material. Most cases of fraud, however, would pass both requirements.³⁰ *The Mercandian Continent* does little on its own to limit the remedy of avoidance for standard types of fraud.

The Aegeon: avoidance does not apply to fraud

- 6.40 In *The Aegeon (No 1)*,³¹ Lord Justice Mance³² sought to make sense of the law on remedies for fraudulent claims following *The Star Sea*. He acknowledged that this was not an easy task:

The waves of insurance litigation over the last 20 years have involved repeated examination of the scope and application of any post-contractual duty of good faith. The opacity of the relevant principles – whether originating in venerable but cryptically reasoned common law cases or enshrined, apparently immutably, in section 17 of the Marine Insurance Act 1906 – is matched only by the stringency of the sanctions assigned.³³

- 6.41 He expressed “the hope that the House of Lords judicially or Parliament legislatively might one day look at the point again”.³⁴

²⁶ Above, at [26].

²⁷ *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* [1995] 1 AC 501.

²⁸ *K/S Merc-Scandia XXXXII v Certain Lloyd's Underwriters (The Mercandian Continent)* [2001] EWCA Civ 1275, [2001] 2 Lloyd's Rep 563, at [28], adopting Rix LJ's statement in *Royal Boskalis Westminster NV v Mountain* [1999] QB 674, [1997] LRLR 523 at [597] that a post-contractual breach of good faith must be ultimately legally relevant to a defence which the insurers had under the policy terms and the insurers must have been induced to change their position.

²⁹ Above, at [26].

³⁰ MacGillivray suggests that “the paradigm cases of the baseless claim, the inflated claim and the suppression of a defence” would likely pass both these versions of the materiality and inducement tests. *MacGillivray on Insurance Law* (11th ed, 2008), para 19-065.

³¹ *Agapitos v Agnew (No 1) (The Aegeon)* [2002] EWCA Civ 247, [2003] QB 556.

³² Now Lord Mance JSC.

³³ *Agapitos v Agnew (No 1) (The Aegeon)* [2002] EWCA Civ 247, [2003] QB 556 at [1].

³⁴ Above at [13].

6.42 In the current state of the law there are three possible approaches to the effect of section 17 on fraudulent claims. The courts could:

- (1) accept a strict interpretation of section 17, and hold that avoidance was the appropriate remedy;
- (2) deny that avoidance was the remedy for all breaches of the duty of good faith; or
- (3) decide that making a fraudulent claim was not a breach of the duty of good faith as set out in section 17.

6.43 Lord Justice Mance tentatively opted for (3). He thought that a solution to the “present imperfect state of the law” would be to:

treat the common law rules governing the making of a fraudulent claim (including the use of fraudulent devices) as falling outside the scope of section 17 On this basis no question of avoidance ab initio would arise.³⁵

Instead, the common law provides a separate rule that the appropriate remedy for fraud is forfeiture of the claim.

6.44 This is a difficult analysis: it is one thing to say that only fraud breaches the insured’s post-contract duty of good faith. It is another thing altogether to say that even fraud does not breach the duty.

6.45 Academics and textbook writers have also struggled to make sense of the current law. MacGillivray takes the view that there are “two separate principles of insurance law, each of which can be invoked in defence by the insurer”.³⁶ Thus, the common law rule referred to by Lord Justice Mance exists side by side with the remedy of avoidance under section 17. The insurer can choose which to pursue.³⁷

6.46 By contrast, Professor Clarke considers there to be a single doctrine: the fraudulent claim fails entirely and the insurer may terminate the contract. Past outstanding honest claims remain enforceable, however, and the insurer cannot recover insurance money paid out in respect of other claims.³⁸

³⁵ Above, at [45]. “Ab initio” means from the start of the contract.

³⁶ *MacGillivray on Insurance Law* (11th ed 2008), para 19-055.

³⁷ This is evident in a subsequent judgment of Lord Justice Mance in which he refers to the common law principle having a separate origin and existence to any principle which exists under section 17. See *Axa General Insurance Ltd v Gottlieb* [2005] EWCA Civ 112, [2005] 1 All ER (Comm) 445, at [20].

³⁸ MA Clarke, *The Law of Insurance Contracts* (4th ed 2002), para 27-2C3.

Axa v Gottlieb: the insurer may not recoup previous claims

- 6.47 The case of *Axa General Insurance Ltd v Gottlieb*³⁹ lends support to Professor Clarke's view. Mr and Mrs Gottlieb claimed under a buildings insurance policy on four occasions during the policy year, and settled two claims without any issue of fraud arising. The insurer made interim payments on the other two claims before discovering that the policyholders had acted fraudulently in pursuing these claims. The insurer sought to recover all the payments it had made.
- 6.48 The Court of Appeal held that the insurer was entitled to recover all interim payments paid in respect of the two fraudulent claims. The other two claims, however, had been paid in full, and had arisen before any fraud had occurred. These were not recoverable.
- 6.49 Lord Justice Mance again explained that the rule against fraudulent insurance claims was a special common law rule, distinct from section 17. Under the rule, the appropriate remedy was "to forfeit the whole of the claim to which the fraud relates". It did not affect prior separate claims, settled under the policy before the fraud occurred. He did not reach a conclusion on whether the insurer would be obliged to pay separate claims which were still unpaid at the time of the fraud. He saw some force in the argument, however, that forfeiture should be confined to the fraudulent claim.

Fargnoli: avoidance is not the appropriate remedy in Scotland

- 6.50 The Scottish courts appear to have achieved the same result through a different route. In *Fargnoli v GA Bonus Plc*,⁴⁰ the pursuer made a claim following a fire at his premises. The insurers alleged that the pursuer had caused, or connived in causing, a second, later fire on the same premises. They argued that this subsequent fraud should lead to the retrospective forfeiture of that first claim. The argument was rejected.
- 6.51 Lord Penrose distinguished pre-contract fraud (where avoidance is appropriate) from post-contract fraud. Pre-contract fraud vitiates the contract. Where there is fraud in making a claim, however, there has been "a valid binding contract" up until the date the fraudulent claim was presented to the insurer: to avoid the policy from the start "would defeat that reality".⁴¹ Furthermore, avoidance was not an appropriate remedy for every want of good faith: the duty was mutual and the remedy was purely one sided.
- 6.52 Instead the remedy for fraud was forfeiture of the claim. Though "a claim tainted by fraud would be cut down as a whole", the pursuer's first claim was a valid one.⁴² Thus the pursuer was entitled to have his first fire claim assessed on the merits, and that earlier claim would be unaffected by the pursuer's alleged subsequent fire-raising attempt.

³⁹ [2005] EWCA Civ 112, [2005] 1 All ER (Comm) 445.

⁴⁰ 1997 SCLR 12; [1997] CLC 653; [1997] 6 Re LR 374.

⁴¹ 1997 SCLR 12, at p 30.

⁴² Above.

THE EFFECT OF FRAUD ON SUBSEQUENT CLAIMS

6.53 A further question is the effect of fraud on a subsequent claim. Suppose an insured householder fabricates some aspect of a water damage claim, but the house burns down during the investigation. Does the policyholder forfeit the subsequent valid claim? There are two possible approaches:

- (1) The fraud is characterised as a breach of the contract, which gives the insurer the right to terminate cover. However, the policy continues to exist until termination, and any claim arising between the date of the fraud and the date of termination must be paid.
- (2) The presentation of the fraudulent claim automatically brings the contract to an end, invalidating any claim which arises after the fraud but before the fraud is discovered.

6.54 There is no definitive ruling on the issue. However, the cases suggest that the first view is favoured. Normal contractual rules apply. On this basis, the fraud amounts to a repudiatory breach of contract, permitting the insurer to terminate the contract. The contract continues, however, until the insurer has exercised its right to terminate. In *Axa General Insurance Ltd v Gottlieb*, Lord Justice Mance put the point as follows:

There seems to me some force in the argument that the common law rule relating to fraudulent claims should be confined to the particular claim to which any fraud relates, while the potential scope and operation of more general contractual principles might in some circumstances also require consideration.⁴³

6.55 In *Fagnoli v GA Bonus Plc*, Lord Penrose made a similar observation. He said that fraud would amount to a repudiatory breach of the contract, entitling the insurer to rescind in accordance with general contract principles. He added, however, that:

rescission does not absolve parties from primary obligations already due for performance at the time of rescission.⁴⁴

CAN THE INSURER SUE THE INSURED FOR DAMAGES?

6.56 One final question is whether an insurer can sue an insured for damages following a fraudulent claim, for example to recover the cost of investigating the claim.

6.57 The answer appears to be no. This was confirmed by *London Assurance v Clare*,⁴⁵ which held that the cost of investigation is not recoverable under an implied term not to commit fraud.

⁴³ [2005] EWCA Civ 112, [2005] 1 All ER (Comm) 445, at [22].

⁴⁴ 1997 SCLR 12, at p 22. Rescission is the standard Scots law term for termination of a contract for material breach. (See W W McBryde, *The Law of Contract in Scotland* (3rd ed, 2007), para 20-05). Rescission in Scots law is, generally, prospective rather than retrospective in effect. (See W W McBryde, *The Law of Contract in Scotland* (3rd ed, 2007), para 20-109).

6.58 It remains open to an insurer, however, to argue that it is entitled to claim damages for deceit following a fraudulent claim. In *Insurance Corporation of the Channel Islands Ltd v McHugh*,⁴⁶ allegations of deceit were pleaded by the insurers but not pursued at trial. If they had been, Mr Justice Mance noted that an action for deceit might have been arguable in principle.⁴⁷

CONCLUSION

6.59 The area of controversy is relatively small. In many cases, the courts simply give effect to an express term setting out the insurer's remedies for fraud. In other cases, the insurer is only concerned with the effect of the fraud on the claim in hand: here the law is clear that the whole claim is forfeited and any interim payments made on those claims may be recouped.

6.60 There are, however, three unresolved issues:

- (1) Does a fraudulent claim affect a previous claim made under the same policy?
- (2) Does a fraudulent claim affect subsequent claims made before the insurer has taken action to terminate the contract?
- (3) May the insurer sue the insured for damages to recover the cost of investigating a fraudulent claim?

6.61 As we have seen, these issues have generated considerable case law and debate, as the courts struggle to reconcile the apparently clear words of section 17 with principle and logic.

6.62 Although the three points of contention are relatively narrow ones, we think that reform is needed. It is common for commercial insurance policies to cover many different goods, or many different risks. For example the policy in *The Star Sea*⁴⁸ covered 33 ships. Small businesses are increasingly using combined policies, covering vehicles, property and liability. In these circumstances, the difference between forfeiting the claim and avoiding the whole policy may be significant.

6.63 Moreover, it is particularly important that the law in this area is clearly articulated and understood. The more confused the rules, the less they will deter fraud.

⁴⁵ (1937) 57 Ll L Rep 254, by Goddard J, at p 270.

⁴⁶ [1997] 1 LRLR 94.

⁴⁷ Above at 125.

⁴⁸ *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd and Others (The Star Sea)* [2001] UKHL 1, [2003] 1 AC 469.

6.64 Only Parliament can change section 17. We think it is time for statutory reform, to set out the remedies for fraud. As we explain in Parts 7 and 8, we think that fraud should lead to forfeiture of the whole claim to which the fraud relates *and* forfeiture of any subsequent claim. It should, in some circumstances, give the insurer the right to claim damages. It should not, however, affect any previous claims, whether or not they have been paid.

PART 7

INSURERS' REMEDIES FOR FRAUD: THE CASE FOR REFORM

- 7.1 The law on remedies for fraudulent claims is convoluted. Section 17 of the Marine Insurance Act 1906 appears to entitle an insurer to avoid the contract, and recoup any claims already paid. Yet the common law has diverged from this harsh position and holds that the appropriate remedy is forfeiture only of the fraudulent claim. This disjuncture has generated unnecessary complexity and uncertainty. In this Part we set out the case for statutory reform.

A NEW STATUTORY CODE

- 7.2 In Issues Paper 7 we tentatively proposed legislative reform and invited views.¹ The great majority of consultees agreed that legislation was needed to clarify this confusing area. Out of the 25 responses that addressed the question, all but four agreed that the law was unnecessarily complex. All but two thought that it would be helpful to introduce legislation to clarify the insurers' remedies.
- 7.3 The Association of British Insurers (ABI) acknowledged the various, conflicting ways in which fraud by the insured has been characterised. It favoured straightforward legislation:

The duty not to make a fraudulent claim has been characterised in several irreconcilable ways by the courts. It has been considered both as an implied term of the insurance policy,² and as a breach of section 17 of the Marine Insurance Act 1906,³ for which the insurer's civil remedy was avoidance of the policy ab initio. It has also since been recognised as a distinct common law rule based on public policy,⁴ where the insurer's remedy was forfeiture of the claim and permission to rescind the policy. Alternative positions have thus been created as to the remedies available to insurers in respect of fraudulent claims, but none long-established.

- 7.4 Kennedys LLP, a law firm, emphasised the importance of clarity in acting as an effective deterrent against fraud:

For the law relating to fraudulent claims to be an effective deterrent, it should be clear and well understood, particularly as to what the consequences will be of any breach. Most opportunists do not appreciate that if they were to fraudulently exaggerate or fabricate part of a claim they risk receiving nothing at all.

¹ Insurance Contract Law, Issues Paper 7: The Insured's Post-Contract Duty of Good Faith (July 2010), paras 4.58 to 4.59.

² *Orakpo v Barclays Insurance Services Co Ltd* [1994] CLC 373. (ABI fn)

³ *Black King Shipping Corporation v Massie (The Litsion Pride)* [1985] 1 Lloyds Rep 437. (ABI fn).

⁴ Mance LJ in *The Aegeon (No 1)* [2002] EWCA Civ 247, [2003] QB 556. (ABI fn).

- 7.5 The Forum of Insurance Lawyers (FOIL) agreed: given the “moral ambivalence” of the public surrounding the serious problem of fraudulent insurance claims, statutory reform would provide a clear reminder of the duties owed by the insured.
- 7.6 Interestingly, the consultees who argued that the law was clear disagreed about what the legal position was. An academic commentator thought that the remedy was clearly forfeiture of the claim, stating that “the common law rule following especially [*The Aegeon*] is a clear and incontrovertible part of English law”.⁵
- 7.7 By contrast, two respondents argued that the “clear” legal position included the right to avoid: the remedies of avoidance and forfeiture continued to exist alongside each other.
- 7.8 The responses we received have convinced us that there is a strong case for a new statutory provision setting out the remedies available to an insurer if a policyholder acts fraudulently.

FORFEITURE RATHER THAN AVOIDANCE

- 7.9 In Issues Paper 7, we proposed that an insured who makes a fraudulent claim should forfeit the whole claim to which the fraud relates. The fraud should not, however, invalidate previous, legitimate claims. The majority of consultees (17 of 21 who addressed the point) agreed.
- 7.10 The main argument against avoidance as a remedy for fraud is that it is unprincipled. It seems wrong that a valid claim made under a valid policy can be undermined by subsequent events. Roy Rodger, a broker, told us that this brings the industry into disrepute:

There is no way the law should permit insurers to avoid a policy back to inception on the basis of a fraud that occurred several years after inception. That does not do our industry any credit.

- 7.11 As Royal & Sun Alliance put it:

Any pre-existing valid claims should be dealt with on their merits, although these may be scrutinised again to ensure that they were honestly made.

- 7.12 We agree that insurers should be entitled to investigate previous claims, on the basis that they may have been fraudulent but had not been detected at the time. Valid claims, however, should not be recouped. As RBS Insurance put it:

There should be no automatic retroactive penalty if there was no intention to commit fraud previously. However, we believe that insurers should have the right to review and re-investigate previously paid claims, where a subsequent one is found to be fraudulent.

⁵ Johanna Hjalmarsson of Southampton University.

- 7.13 The second argument against avoidance is that it is impractical. The courts are reluctant to grant it. And even if the insurer won in court, a judgment may prove difficult to enforce, as the money is likely to have been spent.
- 7.14 Those who argued for avoidance acknowledged that it would be applied extremely rarely. Nevertheless, it was thought to be a useful tool in some circumstances. The ABI, for example, argued that insurers should still be permitted to have recourse to avoidance of the policy as a last resort. FOIL commented that “such a far reaching remedy will be inappropriate in the majority of cases but it should still be available in extreme circumstances”.
- 7.15 It is possible that some insurers may still use avoidance as a threat against suspected fraudsters, even if the threat is usually a hollow one. The proposals we are making, however, strengthen the insurer’s remedies for fraud, by clarifying the effect of fraud on subsequent claims and by providing a limited right of damages. Under this scheme, we think that the additional threat of avoidance is unnecessary.
- 7.16 As discussed in Part 8, we propose to end the remedy of avoidance under section 17. Avoidance of past claims is unprincipled and impractical, and appears unnecessarily harsh. Instead, valid past claims should be unaffected by a subsequent fraud. This reflects the approach already taken by the courts and by good market practice.

SUBSEQUENT CLAIMS

- 7.17 The courts have held that a fraudulent claim amounts to a repudiatory breach of the contract, giving the insurer the right to terminate the contract. After termination, no claims are payable. It is unclear, however, whether the insurer must pay claims arising between the date of the fraud and the date of the termination. As we saw in Part 6, some statements in the case law suggest that such claims should be paid, but there is no definitive ruling on the issue.⁶
- 7.18 In Issues Paper 7, we tentatively proposed that valid claims arising between the date of the fraud and the termination should be paid. We suggested that this was in line with normal contract principles, in which terminating a contract only brings a contract to an end after the termination.
- 7.19 Most insurers and practitioners disagreed, arguing that fraud should bring the contract to an end immediately. After consulting more widely on this issue, we have changed our approach. The argument against avoidance for previous claims is that it is unprincipled and impractical. These arguments were thought not to apply to subsequent claims.
- 7.20 First, as a matter of principle, it was felt that the insured’s actions had undermined the contractual relationship, bringing the insurer’s obligations to an end. Fraud undermined the necessary trust and good faith between the parties. Derrick Cole and Geoffrey Lloyd noted:

⁶ See para 6.53 and following above.

Having discovered fraud, it would be perfectly normal for the insurer to be extremely wary of subsequent claims for which they were still on risk. Trust would have evaporated.

- 7.21 Secondly, as a matter of practice, a rule which required the insurer to take action to terminate the contract would encourage premature allegations of fraud. Beachcroft, a law firm, put the point as follows:

Fraud investigations can take considerable time and fraud is not an allegation to be made lightly. If termination is not to take place until the claim has been refused, insurers will feel that their hand is being forced to make knee jerk allegations of fraud in order to avoid more claims. This will not benefit either insurers or insureds.

- 7.22 The FOS agreed:

In practice, the policy normally specifies that the termination dates from the fraud. It might be detrimental to consumers if the law encouraged insurers to exercise the right to terminate prematurely without fully investigating an allegedly fraudulent claim.

- 7.23 The denial of subsequent claims appears to be common market practice. Insurers frequently include express policy terms which specify that following a fraud, subsequent claims will not be covered. As we saw in Part 6, the courts are willing to uphold such terms.⁷ Insurers may also reserve their rights upon being presented with a claim.

- 7.24 In Part 8 we propose that a fraudster should not only forfeit the claim to which the fraud relates but also all subsequent claims. We acknowledge that this is in line with current market practice.

- 7.25 An insurer would, however, still have a duty to act in a timely manner, either to reserve its rights or to terminate cover. As RBS noted, if an insurer was aware of a fraud and did nothing, this would constitute a waiver of the right to refuse subsequent claims.

DAMAGES FOR CLAIMS INVESTIGATION

- 7.26 As we saw in Part 6, the legal position appears to be that an insurer cannot claim damages for the reasonable and foreseeable costs of investigating a fraudulent claim. However, the possibility of damages for deceit remains.⁸

- 7.27 In Issues Paper 7 we asked an open question on this issue: did consultees think that an insurer should be entitled to claim damages for the reasonable and foreseeable costs of investigating a fraudulent claim?

⁷ *Joseph Fielding Properties v Aviva Insurance* [2010] EWHC 2192, [2011] Lloyd's Rep IR 238.

⁸ See para 6.58.

7.28 The present law provides a strong deterrent against exaggeration. The consequences of exaggeration may be severe. For example, in *Aviva v Brown*,⁹ a consumer suffered subsidence, and had to move out of his home while the insurers carried out repairs. The consumer fraudulently claimed he was paying rent on the new property, whereas in fact he owned it. He not only forfeited the £58,500 in rent, but also the £177,000 for repairs.

7.29 By contrast, the civil law provides no deterrent against complete fabrication. If policyholders lie about the entire claim, they risk little actual loss. We thought that in the circumstances, there was a case for permitting the insurer to claim damages for the reasonable and foreseeable cost of investigating the fraud.

Support for damages claims

7.30 All but two respondents argued that insurers should be entitled to claim damages for investigation costs. It was thought that this would convey an effective anti-fraud message to potential fraudsters. Furthermore, the costs of investigating fraud can be substantial and insurers should be compensated for their actual losses. As Zurich noted:

Insurers are incurring significant costs in creating ever more sophisticated business tools and processes to deter the professional fraudster. We believe that insurers should have the right to recover investigation costs. These costs would not have been incurred had it not been for the deceitful actions of the policyholder.

7.31 It was pointed out that in some cases, insurers succeed in claiming such costs. As Keoghs noted, however, a statutory remedy would be an improvement on the current practice of claiming under the tort of deceit:

At present an insurer must bring a successful action in the tort of deceit to obtain this remedy which can be expensive and complex. Introducing a simple statutory remedy would act as a deterrent to fraudsters, thereby benefitting the insurance industry and society in general and honest policyholders in particular.

Concerns about damages claims

7.32 Some concerns were expressed about such claims. The FOS argued that damages claims were unfair, as the cost of investigating claims was an integral part of the insurer's business. The General Council of the Bar argued that such damages were impractical:

We are of the view that in most cases insurers would find it difficult to recover such damages as in our experience, most fraudsters either do not have substantial means or have managed to conceal such assets as they have.

7.33 Furthermore, unlimited damages may impose an excessively onerous burden on insureds. Ray Hodgkin of Birmingham University noted:

⁹ [2011] EWHC 362 (QB).

The costs could get out of hand. I seem to remember long ago [an insurer] in one of its annual reports noting that the smallest appeal to it was for £5. If an insurer is prepared to go to such lengths then it is possible that a fraudulent claim for a small sum might escalate into a very large costs claim.

Limiting damages to “actual loss”

7.34 In Issues Paper 7, we suggested that damages should only cover net losses. Insurers should not be compensated for the costs of investigations where they had already recouped those costs through the savings accrued from not paying the legitimate element of the claim.¹⁰ We thought that in a case such as *Aviva v Brown*,¹¹ where the insurer had already saved £177,000 in not paying a legitimate claim, it would be disproportionate also to require the consumer to pay large costs. This would effectively provide the insurer with double recovery.

7.35 The Faculty of Advocates supported our limitation, noting:

To the extent that the costs of investigation were offset by the savings made, there is no recoverable loss.

7.36 Others felt that this would be an unnecessary complication. The ABI’s views were repeated by several consultees:

The ABI considers that prohibiting the insurer to recover costs from the fraudulent policyholder will only serve to weaken the deterrent to potential fraudsters.

7.37 In Part 8, we propose to introduce a statutory right for the insurer to claim damages for the reasonable, foreseeable costs of investigating a fraudulent claim in some circumstances. We do not wish to see this used, however, to impose excessive costs on those who have already suffered substantial losses through forfeiture of the legitimate elements of their claims. Damages would be limited to those cases where the insurer can show a net loss.

EXPRESS TERMS

Business insurance

7.38 As described in Part 6, many insurance contracts use express “fraud clauses” to extend the insurer’s remedies for fraud. In commercial contracts, the courts are prepared to uphold such clauses, provided they are written in unambiguous terms. In the Issues Paper, we argued that freedom of contract should be preserved, and all but two consultees agreed.

¹⁰ Insurance Contract Law, Issues Paper 7: The Insured’s Post-Contract Duty of Good Faith (July 2010), paras 7.39 to 7.43.

¹¹ [2011] EWHC 362 (QB).

- 7.39 In Part 8, we propose new statutory provisions, setting out the remedies available to an insurer in the absence of a specific term. The question is whether, in dealing with businesses, an insurer should be entitled to add to these remedies through an express term. In particular, should an insurer be entitled to specify that fraud will lead to the avoidance of the contract?
- 7.40 The argument for giving effect to such a clause is that the parties should be entitled to reach the agreement that best suits their needs. The argument against is that very few small to medium sized businesses are likely to understand the effect of “avoidance”. Policyholders are unlikely to understand that the phrase “avoid the contract” means that the insurer can demand the repayment of a valid claim paid under a valid contract, which is wholly unconnected to the fraud. We have already described the remedy of avoidance as unprincipled and impractical. It is more likely to be used as a threat in negotiations rather than be a practical consequence of fraud.
- 7.41 As we discussed in Part 1 our starting point is to preserve freedom of contract.¹² In Part 8 we provisionally propose that an express fraud clause should be upheld, but only if it is written in clear unambiguous terms and specifically brought to the attention of the insured.
- 7.42 The converse issue is whether the parties should be entitled to use an express policy term to reduce the statutory remedies. In the Issues Paper we discussed how, under the current law, the parties to a contract may not exclude liability for fraud altogether. We concluded that this was right, and all 26 consultees who addressed this point agreed with us.
- 7.43 That said, there is a difference between excluding all liability for fraud and modifying some of the statutory remedies. The same arguments in favour of freedom of contract suggest that the parties should, if they wish, be entitled to reduce the remedies, even if they cannot exclude them all. For example, an express clause might state that fraud would only invalidate the claim to which the fraud relates, and not any subsequent claim. Again, to be valid, we think that any such clause would need to be written in clear, unambiguous terms and be brought to the attention of the other party. For example, if the insured’s broker put such a clause forward, it would need to be brought specifically to the attention of the insurer.

Consumer insurance

- 7.44 In consumer contracts, there is a case for a different approach. We think that the statutory rules we have outlined provide clear, effective deterrents against fraud in consumer insurance. If a term were to permit avoidance from the start of the contract, consumers would be very unlikely to understand the implications of this. As the General Council of the Bar put it:

We doubt that most consumers read insurance terms and their policies will invariably be on insurers’ standard terms.

¹² See paras 1.41 and 5.15 and following.

- 7.45 The Unfair Terms in Consumer Contracts Regulations 1999, together with the FOS jurisdiction, already provide some protection. The 1999 Regulations, however, do not provide easy answers. A consumer who wishes to challenge a clause permitting avoidance for fraud would face a difficult task, with an uncertain outcome.
- 7.46 In Part 5, we argued that any term which excluded the insurer's liability for late payment should be of no effect. We think that a similar provision should be included in this context.¹³

Excluding the fraud of agents

- 7.47 As noted in Part 6,¹⁴ there is uncertainty in common law as to whether parties may contractually exclude liability for the fraud of their agents. The point was considered by the House of Lords in *HIH Casualty & General Insurance v Chase Manhattan Bank*.¹⁵ Lord Bingham noted that for such an express term to be valid, it would have to employ language which would:

alert the commercial party to the extraordinary bargain he is invited to make.¹⁶

- 7.48 In this case, the term was too ambiguous to exclude fraud by the agent. The court did not decide on whether it would ever be possible for contracting parties to exclude liability for their own agents' fraud, if the language was sufficiently clear.
- 7.49 In Issues Paper 7, we sought views on the issue: Sixteen of 23 consultees agreed that parties should be entitled to exclude liability for the fraud of their agents if they wished, but many qualified their support.
- 7.50 Several consultees noted that the issue would very rarely arise in practice, as only the most powerful of policyholders would ever be in a position to demand such a clause. BILA did not consider the issue to be important in practice, describing the point as "commercially insignificant". The Lloyd's Market Association noted:

In practice we believe it is highly unlikely that an insurer would agree to take this risk in relation to the insured's broker or sub-broker.

- 7.51 Our consultation revealed no demonstrable need to legislate in this area. Given that such clauses are so rare, the courts would seem to be best placed to resolve any issues. The present position would appear to be that such an exclusion clause may represent a genuinely negotiated bargain, in which case it would be upheld. Any clause excluding liability for an agent's fraud, however, would need to be written in a very clear way. We think this is right, and make no proposals on the issue.

¹³ See paras 5.20 and following.

¹⁴ See para 6.24.

¹⁵ [2003] UKHL 6, [2003] 1 All ER (Comm) 349, [2003] 1 CLC 358.

¹⁶ Above, at [16].

THE FUTURE OF SECTION 17

- 7.52 The changes we are proposing raise questions about the future of section 17 of the Marine Insurance Act 1906, which states that a contract of insurance is “based upon the utmost good faith”. In Issues Paper 7 we asked whether the post-contract duty of good faith applied in other contexts, outside the area of fraudulent claims. We concluded that the duty had limited application. For example, we thought that issues of notification of risk are best handled through express terms rather than as a matter of good faith. Most consultees agreed that the insured should only have a duty to report increases in the risk if the contract included an express term to that effect. Furthermore, any such express term should be interpreted restrictively.¹⁷
- 7.53 As we discussed in Part 5, we think that the duty of good faith is best seen as a shield rather than a sword. It is a general interpretative principle, and it may be used to prevent a party from relying on a contractual provision to justify actions taken in bad faith. It becomes problematic, however, when it is used as a cause of action in its own right, especially as it only specifies one remedy, namely avoidance.
- 7.54 In our next consultation paper, on the pre-contract duty of disclosure in business insurance, we will return to the issue of whether avoidance is always the appropriate remedy for non-disclosure or misrepresentation. At the same time, we will make proposals to reform section 17. Our current thinking is that the duty of good faith should remain as a general principle, but that it should not, in itself, provide any specific remedies. Instead the appropriate remedies for late payment, fraudulent claims, non-disclosure and misrepresentation should be specifically set out in legislation.

CONCLUSION

- 7.55 There is strong support for statutory reform to clarify the remedies for fraudulent claims. Our proposed reforms are designed to strengthen the sanctions against fraud, but to do so in a principled and balanced way.
- 7.56 At present, avoidance is used as a threat rather than a remedy. The courts are extremely reluctant to allow a fraudulent claim to affect a previous, valid claim. The proposed reforms would uphold the existing case law by clarifying that avoidance is not the appropriate remedy for want of good faith during the currency of the contract.
- 7.57 At the same time, the proposed reforms would provide the insurer with firm, practical remedies. First, we intend to clarify that fraud forfeits subsequent claims, even legitimate ones, where the loss arises after the fraud. Secondly, insurers will be entitled to recover reasonable costs of investigating frauds, where these losses are not recouped in other ways. This will provide a penalty in major frauds, where the whole claim is fabricated.

¹⁷ See Issues Paper 7: Summary of Responses, part 6
<http://www.justice.gov.uk/lawcommission/consultations/insureds-postcontract-duty-of-good-faith.htm>

PART 8

INSURERS' REMEDIES FOR FRAUD: PROPOSALS FOR REFORM

- 8.1 Fraud is a serious and expensive problem, and it is important that the law sets out clear sanctions. Yet, the law on the consequences of a fraudulent claim is convoluted and confused, and has generated many conflicting cases. The great majority of respondents to our Issues Paper supported statutory reform.
- 8.2 As discussed in Issues Paper 7, we leave the definition of fraud to the common law. Our proposals deal only with the remedies. We propose that a policyholder who makes a fraudulent claim should forfeit the whole claim to which the fraud relates. The fraudster should also forfeit any subsequent claim which arises after the date of the fraud. Fraud should not however affect any previous valid claims, whether or not the insurer has made a payment.
- 8.3 We propose that insurers should also 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. In other words, damages would be available where the insurer has not been compensated for the investigation costs by the savings from not paying the legitimate element of a forfeited claim.
- 8.4 In business insurance, these provisions form a default position which could be varied or departed from by agreement of the parties. In consumer insurance, an insurer would not be entitled to add to these remedies through a contract term.

A STATUTORY CODE

- 8.5 We provisionally propose a new statutory provision setting out the remedies for a fraudulent claim. Section 17 of the Marine Insurance Act 1906 would no longer apply to fraudulent claims.
- 8.6 Our proposals are in four parts:
- (1) A policyholder who commits a fraud in relation to a claim forfeits the whole claim to which the fraud relates. Any interim payments made in respect of the claim must be repaid.
 - (2) The policyholder also forfeits any claim which arises after the date of the fraud.
 - (3) The fraud does not affect any previous valid claim where the loss arises before the fraud takes place, whether or not the claim has been paid.
 - (4) The insurer has a right to claim the costs reasonably and actually incurred in investigating the claim, provided that the insurer has not already received recompense for these costs through the first and second remedies.

FORFEITURE OF THE WHOLE CLAIM

- 8.7 The remedy of forfeiture is clearly established in case law.¹ The cases establish that any fraudulent exaggeration which is “not insubstantial” leads to the loss of the legitimate element of the claim.² The insurer may recoup any interim payments already made. An example is *Galloway v Guardian Royal Exchange (UK) Ltd.*³ Mr Galloway was burgled and suffered a genuine loss of around £16,000. When he submitted his claim, however, he fabricated a claim for a fictitious computer for around £2,000. The Court of Appeal rejected the whole claim, including the £16,000 of genuine loss.
- 8.8 We intend to give statutory effect to the common law remedy of forfeiture, as established in the existing cases. This means that if a policyholder commits a fraud in relation to a claim, the whole claim is forfeited.
- 8.9 The fraudulent element and the genuine element of the claim do not need to be submitted at the same time, if both are held to be part of a single claim. The courts have tended to give a wide meaning to the concept of single claim, especially where different elements arise from the same incident. For example, in *Yeganeh v Zurich Insurance*,⁴ a policyholder who was fraudulent in his contents claim was held to have lost any right to recover for damage to the premises in which the contents were housed. In *Aviva Insurance v Brown*,⁵ the policyholder claimed for subsidence to his home, which led him to seek alternative accommodation. He claimed rent for alternative accommodation without revealing he owned the property concerned. This was held to be fraudulent. The claims for the cost of the subsidence and for the alternative accommodation were held to be the same claim, as both arose from the same incident. Both the accommodation and the repair elements of the claim were forfeited.⁶
- 8.10 Our view is that the meaning of the concept of a single claim (and how wide that interpretation should be) is best left to the courts to develop, based on the facts and circumstances of each case.

¹ *Galloway v Guardian Royal Exchange* [1999] Lloyd’s Rep IR 209; *Agapitos v Agnew (No 1) (The Aegeon)* [2002] EWCA Civ 247, [2003] QB 556; *Axa General Insurance Ltd v Gottlieb* [2005] EWCA Civ 112, [2005] 1 All ER (Comm) 445. In Scotland, see discussion in *Fargnoli v GA Bonus Plc* 1997 SCLR 12, [1997] CLC 653, [1997] 6 Re LR 374.

² For further discussion of the meaning of “not insubstantial” see Insurance Contract Law, Issues Paper 7: The Insured’s Post-Contract Duty of Good Faith (July 2010), paras 3.4 to 3.29.

³ [1999] Lloyd’s Rep IR 209.

⁴ [2010] EWHC 1185, [2011] Lloyd’s Rep IR 75. Subsequently overturned by the Court of Appeal ([2011] EWCA Civ 398) on unrelated grounds – we are grateful to Professor Merkin for raising this issue.

⁵ [2011] EWHC 362 (QB).

⁶ Above at [122].

FORFEITURE OF SUBSEQUENT CLAIMS

- 8.11 The effect of a fraud on subsequent claims is uncertain. It is clearly established that fraud gives the insurer the right to terminate a contract with prospective effect. There is some doubt, however, about the status of claims which arise between the time of the fraud and the time of termination.
- 8.12 We have been persuaded by the arguments put to us that subsequent claims should also be forfeited, even if the claim arises before the insurer discovers the fraud or has taken steps to terminate the contract. It was thought to be more practical than the alternative, which would encourage insurers to rush to terminate the contract on the slightest suspicion of fraud. As we explain in the examples set out below, a fraud would effectively discharge the insurer from liability for any loss which takes place after the date of the fraudulent act, whether or not the fraud has been discovered.
- 8.13 That said, on discovery of a fraud, the insurer is expected to take some action to communicate the finding to the insured and terminate the cover. If an insurer has evidence of fraud and takes no action, it will be taken to have waived its defence to a subsequent claim.

NO AVOIDANCE OF PREVIOUS VALID CLAIM

- 8.14 In Part 6, we discussed the remedy of avoidance as set out in section 17 of the Marine Insurance 1906. Despite the clear words of the statute, the courts have been reluctant to allow insurers to recoup valid claims already paid under the contract. As Lord Penrose stated in *Fagnoli v GA Bonus Plc*, the penalty of a fraudulent claim should “not extend beyond the offence to deprive persons of innocent benefits, or benefits otherwise free from the taint of fraud”.⁷
- 8.15 As discussed in Part 7, avoidance was thought to be unprincipled and of little practical value. We were told that very few insurers attempt to invalidate previous legitimate claims. The majority of respondents to Issues Paper 7 agreed that a fraudulent claim should not affect previous claims, whether or not they have been paid. This included several leading insurers.

EXAMPLES

- 8.16 The following examples illustrate the application of these proposals. Suppose that an insured has taken out a buildings policy, and, over the term of the policy, the following events take place.

Example 1: second claim is fraudulent

January: A fire occurs on the insured’s premises, which destroys 100 computers on the site. The insured makes a legitimate claim for the loss.

March: Whilst the first claim is being considered, a flood occurs, which destroys a further 50 computers. The insured makes a fraudulently exaggerated claim for 75 computers.

⁷ 1997 SCLR 12, at p 39.

In this case, the whole of the March claim is forfeited, but the insurer must pay the January claim, which is unaffected by the subsequent fraud.

Example 2: first claim is fraudulent

January: The fire destroys 100 computers on the site.

February: The insured claims for the fire, submitting a fraudulently exaggerated claim for 125 computers.

March: Whilst the first claim is being considered, a flood destroys a further 50 computers. The insured makes a legitimate claim.

April: The insurer discovers the February fraud, and writes to terminate the contract.

Here, under our proposals, the insurer is not liable to pay either claim. The January claim is forfeited as a result of the fraudulent exaggeration. The fraud also effectively ends the insurer's liability under the contract, from the date the fraudulent claim is submitted, in February.

Example 3: fraud committed after second loss

January: The fire destroys 100 computers on the site. The insured initially submits a genuine claim.

March: A flood destroys a further 50 computers.

April: The insured submits a fraudulent claim in respect of the January fire, claiming for 25 additional computers.

May: The insured makes a legitimate claim for the March flood.

Here the insurer is not liable to pay the January claim: the whole claim is forfeited as result of the April fraud. However, the insurer is still required to pay the legitimate claim for the March flood, as the loss took place before the fraudulent act. It is as if the insurance was automatically brought to an end in April. If this has happened, the insurer would remain liable to pay the March losses. In practice, of course, the insurer is likely to scrutinise the May claim very carefully.

8.17 Do consultees agree that a policyholder who commits a fraud should:

- (1) forfeit the whole claim to which the fraud relates?**
- (2) also forfeit any claim where the loss arises after the date of the fraud?**
- (3) be entitled to be paid for any previous valid claim which arose before the fraud took place?**

- 8.18 **Do consultees agree that the definition of “the whole claim” should be left to the courts?**

DAMAGES FOR ACTUAL LOSS

- 8.19 Under the current law, damages are not available for post-contract breaches of good faith by the insured.⁸ In *London Assurance v Clare*,⁹ this was held to mean that damages in respect of the cost of investigating a fraudulent claim were not available. It is possible that the insurer may be able to claim damages for deceit.
- 8.20 We think that damages should be available to cover the reasonable costs of investigating a claim in limited circumstances. Insurers can incur substantial costs in investigating increasingly sophisticated fraud. To make damages available in some cases would provide a deterrent to claims which are entirely fabricated, and the remedy of forfeiture has little practical effect. That said, damages are intended to compensate insurers for actual loss. Insurers should not be entitled to “double recovery”, where the savings made from the forfeited claim already offset the costs of investigation.
- 8.21 The following examples illustrate our proposal:

Example 1

An insured suffers a genuine loss of £1,000 and uses a fraudulent device to claim a further £100. When the fraud is discovered, the insured forfeits the entire claim for £1,100.

The insurer has spent £500 investigating the claim. It is not entitled to any damages for claims investigation, as it has effectively “saved” £1,000 in not having to pay out in respect of the genuine loss.

Example 2

An insured suffers a genuine loss of £5,000 and uses a fraudulent device to claim a further £5,000. When the fraud is discovered, the insured forfeits the entire claim for £10,000.

The insurer has spent £6,000 investigating the claim. Provided that these costs are reasonable, and reasonably incurred in the circumstances, it is entitled to the costs of investigation, minus the monies recouped from not paying the legitimate element of the claim. Therefore, the insurer is entitled to £1,000 in damages.

⁸ *La Banque Financier de la Cite v Westgate Insurance Co* [1987] 2 WLR 1300.

⁹ (1937) 57 LI L Rep 254 by Goddard J at p 270.

Example 3

An insured makes a wholly fraudulent claim of £10,000. The insurer has spent £1,000 investigating the claim. It is entitled to the whole of the costs.

What must the insurer prove?

8.22 To establish a damages claim, the insurer would need to prove all the elements of the claim. It would therefore need to show that:

- (1) The policyholder committed a fraud; and
- (2) the insurer actually incurred costs in investigating the fraud. The insurer will need to prove each expense. It would not be entitled to a standard cost or to a proportion of the costs of running the claims department, such as office overheads; and
- (3) the costs were reasonable and proportionate in the circumstances; and
- (4) the costs were not offset by any saving from legitimate, forfeited claims.

8.23 **Do consultees agree that the costs of investigating proven fraud should be recoverable if the insurer can show that the costs were:**

- (1) actually incurred?**
- (2) reasonable and proportionate in the circumstances?**
- (3) not offset by any saving from legitimate, forfeited claims?**

EXPRESS TERMS

Business insurance

8.24 Many insurance contracts use express “fraud clauses” to extend the insurer’s remedies for fraud. In business contracts, the courts are prepared to uphold such clauses, provided they are written in unambiguous terms.

8.25 We provisionally propose that an express fraud clause should be upheld, but only if it is written in clear unambiguous terms and specifically brought to the attention of the other party. Thus it would be open to an insurer to extend the remedy for fraud, for example to include avoidance of the contract. The clause would, however, need to be clearly written and highlighted in the pre-contract documents.

8.26 An insurer may also agree to reduce the sanctions against fraud, provided that the contract does not exclude liability completely. Again, the clause would need to be clear and unambiguous. If it were put forward on the insured’s behalf, it would need to be drawn to the insurer’s attention.

8.27 **Do consultees agree that in business insurance:**

- (1) the remedies for fraud should be subject to an express term of the contract?**

- (2) **a clause which changes the statutory remedies should be written in clear, unambiguous terms and specifically brought to the attention of the other party?**

Consumer insurance

- 8.28 In consumer contracts, we think that the statutory remedies should not be extended by contract. Consumers are unlikely to understand the implications of “avoidance”, or be able to exercise any bargaining pressure. The Unfair Terms in Consumer Contracts Regulations 1999, together with the FOS jurisdiction, already provide some protection. A consumer who wishes to challenge a clause permitting avoidance for fraud would, however, face a difficult task, with an uncertain outcome.
- 8.29 We propose that in consumer insurance, any term which purports to give the insurer greater rights in relation to fraudulent claims than those set out in statute would be of no effect.
- 8.30 **Do consultees agree that in consumer insurance, any term which purports to give the insurer greater rights in relation to fraudulent claims than those set out in statute would be of no effect?**

PART 9

INSURERS' REMEDIES FOR FRAUD: CO-INSURANCE AND GROUP INSURANCE

- 9.1 In this Part we consider the specific issues which arise when a fraudulent claim is submitted by a co-insured, or by a member of a group scheme.

CO-INSURANCE

- 9.2 Difficult questions arise where two or more policyholders are insured under the same policy, and one policyholder commits fraud or deliberate destructive acts. How far does fraud by one party affect the other party's rights? Where two or more people take out insurance jointly to protect their property, the law usually treats them as acting together. As a result, fraud by one party will result in forfeiture of the other party's share of the claim. This can lead to harsh results where the parties have become estranged.

A summary of the current law

- 9.3 If the fraudster is found to have made the claim on behalf of the other policyholder, the fraudster will be treated as an agent whose fraud is attributed to the principal "innocent" policyholder.¹ If the fraudster did not act as an agent, then the court must decide whether the insurance policy was a "joint" policy or a "composite" policy.
- 9.4 The distinction between joint and composite policies does not necessarily depend on the policy wording² and can be uncertain. If both parties own the property jointly³ and have a single interest, then the policy is usually considered to be a joint one. If the co-insureds have different interests or rights to the property, then the policy will be considered composite.
- 9.5 Under a composite policy, the obligations are said to be "several" and thus misconduct by one policyholder will not affect the claim of the others.⁴ Mr Justice Rix has explained that a composite policy can be understood as a "bundle of separate contracts".⁵

¹ This was illustrated by *Black King Shipping Corporation and Wayan (Panama) SA v Mark Ranald Massie ("The Litsion Pride")* [1985] 1 Lloyd's Rep 437; and in *Direct Line Insurance Plc v Khan* [2001] EWCA Civ 1794, [2002] Lloyd's Rep IR 364.

² Co-insureds with a joint insurable interest can obtain composite cover, and vice versa. It is implicit in the decision of the Court of Appeal in *Direct Line Insurance Plc v Khan* [2001] EWCA Civ 1794, [2002] Lloyd's Rep IR 364 that joint tenants could insure compositely if they wanted to.

³ The equivalent term in Scots law is common property; joint property refers only to property held by trustees or unincorporated associations. See KGC Reid *The Law of Property in Scotland* (1996), para 34.

⁴ *P Samuel & Co Ltd v Dumas* [1924] AC 431; *New Hampshire Ins Co v MGN Ltd* [1997] LRLR 24.

⁵ *Arab Bank Plc v Zurich Insurance Co* [1999] 1 Lloyd's Rep 262, at p 277.

- 9.6 The opposite is true under a joint policy. As Viscount Cave has explained, where two policyholders are jointly insured, “the misconduct of one is sufficient to contaminate the whole insurance”.⁶
- 9.7 A possible scenario where this might lead to injustice is where a husband and wife take out joint insurance on their joint property, and one commits an act as deliberate retribution against the other, such as burning down the matrimonial home. This scenario has arisen in other jurisdictions,⁷ but has not been faced by the English and Scottish courts. Other common law jurisdictions have been sympathetic to an innocent co-insured who has suffered from the wrongful act of a co-insured, and have found ways to allow the innocent party to recover his or her share of the loss.⁸
- 9.8 In Issues Paper 7, we thought that it was right to protect innocent joint policyholders in these circumstances. We tentatively proposed legislation to protect a joint policyholder who could prove that a fraud or wrongful act was carried out without his or her knowledge.

Consultees’ views

- 9.9 Most consultees supported our proposal in principle, but many queried how it would operate in practice. There were two elements: a rebuttable presumption that fraud is committed on behalf of all parties; and a requirement that recovery is limited to the innocent insured’s interest. We look at each element below.

A rebuttable presumption that fraud is committed on behalf of all parties

- 9.10 We suggested that in joint insurance there should be a presumption that any fraud committed by one party is done on behalf of all parties. It should be open to an innocent party, however, to rebut this presumption. Innocent parties who produce evidence that the fraud was not carried out on their behalf or with their knowledge, should be paid their share of the claim.
- 9.11 The proposal was popular, with 16 of 21 consultees supporting the idea in principle. It was felt to strike a more balanced approach between the parties (often conflicting) interests under a joint policy, and protect those who were clearly innocent of wrongdoing. Several consultees, however, queried whether the idea was workable. They asked how a policyholder could prove a negative, namely non-involvement in a fraud.

Limiting recovery to the innocent insured’s interest

- 9.12 We also suggested that recovery should be limited to the innocent insured’s own interest, and that the claim should be payable only where the guilty insured would not benefit.

⁶ *P Samuel & Co Ltd v Dumas* [1924] AC 431, at p 445.

⁷ In the US, see *Klemens v Badger Mutual Insurance Co of Milwaukee* (1959) 8 Wis 2d 565, 99 NW 2d 865. In Australia, see *Holmes v GRE Insurance Ltd* [1988] TASSc 14; (1988) Tas R 147. In New Zealand, see *Maulder v National Insurance Company of New Zealand Ltd* [1993] 2 NZLR 351.

⁸ For discussion, see Insurance Contract Law Issues Paper 7: The Insured’s Post-Contract Duty of Good Faith (July 2010), Part 5.

- 9.13 Most consultees (15 of 21) agreed, but many expressed concern about the practical operation of the proposal. Consultees worried that where the parties were married, it would be difficult for an insurer to value the innocent policyholder's share. As Royal & Sun Alliance (RSA) pointed out, "where the property is jointly owned, even the divorce courts have difficulty in separating interests". They asked:

What is [the innocent party's] share? 50%? Should this take account of the length of time the couple have been married? Or the assets that they brought into the relationship? Income? Children and their age? What one party has put into a relationship? 50% is just a figure and means nothing in terms of legal entitlement.

- 9.14 RSA also thought it would be difficult to prevent the guilty party from benefitting, particularly where couples separate and then reconcile. Additionally, for home insurance, consultees queried how an insurer might be expected to reinstate half a house. The ABI summarised these concerns as follows:

We are concerned that in many circumstances, the guilty party will benefit from his own fraud, for instance where the joint policyholders continue to cohabit or where they live apart for a while and subsequently reconcile. How is the insurer expected to quantify the rateable proportion of an indemnity, and to rebuild half of a jointly owned property burnt to the ground by the jealous husband without benefitting him, for example?

- 9.15 Several consultees suggested that there may be unintended consequences to the proposal. For example, the International Group of P&I Clubs queried whether the case had been made for reform in commercial policies, for which insurers ought to retain the freedom to incorporate express terms and conditions.

- 9.16 Yet, despite these difficulties, many consultees expressed support for the proposal. They felt that the complexities of valuing an innocent party's share was not a reason for denying the innocent party's claim altogether.

Conclusion

- 9.17 The typical problem with which we are concerned is where a husband and wife take out joint insurance on the matrimonial home, and one spouse acts unilaterally in burning it down. There is a clear case to protect the innocent spouse by allowing the innocent party to claim his or her share of the loss. This problem has arisen in several common law jurisdictions, and the courts have generally found a way to do justice in the individual case.

- 9.18 The question is whether this issue requires a legislative solution. Any legislation will need to deal with complex issues of proof and valuation, and may prove a blunt way of dealing with the sensitivities involved. We would not wish to legislate in the absence of a demonstrable need.

- 9.19 We have not found evidence that fraudulent claims in co-insurance are a problem in practice. Although cases have been decided in other jurisdictions, the scenario has yet to arise before the English or Scottish courts. We have only found one such case in the Financial Ombudsman Service records. We suspect that many insurers already pay the innocent party's claim without relying on their strict legal rights. And if the issue were to be taken to court, we think that the courts could find a fair solution, by applying the reasoning used by other Commonwealth courts.
- 9.20 Our current view on the basis that there appears to be no evidence of a significant issue, is that legislative intervention is not necessary. If however, there is significant evidence to the contrary we may reconsider the position. We invite consultees to tell us about any problems they have experienced with the law of fraudulent claims in joint insurance. In the absence of such evidence, we do not currently propose legislative reform on this issue.
- 9.21 **Do consultees have evidence that the law of fraudulent claims by joint insureds causes problems in practice? If so, we would be grateful if consultees could provide us with such evidence or examples, and also provide us with information on how these issues were dealt with (either by the firm concerned or by any other body).**
- 9.22 **Do consultees agree that there is no need to legislate on the effect of fraud by one joint insured on the other joint insured's claim?**

GROUP INSURANCE

- 9.23 Group insurance is a common way to provide life insurance and other long-term benefits. Typically an employer or other policyholder takes out insurance for the benefit of employees or other members of a definable group. The individual members are not however party to the policy of insurance. Payments are often discretionary and individual members do not have any enforceable right to them.⁹ Swiss Re has estimated that group schemes provide over 60% of long-term income protection benefits and nearly 40% of life cover.¹⁰ Yet the law is underdeveloped.

⁹ See *Green v Russell* [1959] 2 QB 226. Insurers also exclude the possibility of members gaining rights under the Contracts (Rights of Third Parties) Act 1999. In Scots law, members might acquire a *jus quaesitum tertio* (a right acquired by a third party in a contract between others) but only if there was an intention to benefit them. See, for example, *Love v Amalgamated Society of Lithographic Printers* 1912 SC 1078.

¹⁰ Figures provided by Swiss Re for the Consumer Insurance Law Project.

- 9.24 As group members are not parties to the insurance contract, the normal obligations that apply to policyholders do not apply to them. In our 2009 Report, *Consumer Insurance: Pre-Contract Disclosure and Misrepresentation*, we noted that group members are not subject to the obligations on policyholders to give pre-contract information. Thus the Consumer Insurance (Disclosure and Representations) Bill makes special provision for group schemes. The Bill ensures that the duty on policyholders to answer questions honestly and carefully also applies to group members. Furthermore, the Bill clarifies that if a misrepresentation is made by a group member, it has consequences only for that individual. This Bill was introduced into the House of Lords on 16 May 2011.¹¹
- 9.25 The same issue arises in connection with fraudulent claims. As group members are not policyholders, they do not appear to be subject to the sanctions that apply to policyholders who make fraudulent claims. Thus if a group member fraudulently exaggerates a loss, the normal rules of forfeiture do not apply. As we understand the law, the only penalty is that the member would not receive the fraudulent element of the claim.

Consultees' views

- 9.26 In Issues Paper 7, we asked whether legislation on fraudulent claims should make special provision for group schemes, along the lines of the provisions in the Consumer Insurance (Disclosure and Representations) Bill. The effect of our proposal would be that a group member who acts fraudulently to obtain a benefit under the group scheme would forfeit the whole benefit, and any subsequent benefit, and would be liable to pay the insurer's reasonable costs of investigating the fraud.
- 9.27 Most consultees agreed that special statutory provisions were needed. As the General Council of the Bar noted:

At present, whilst a group member's fraudulent claim would not succeed to the extent that it was fraudulent ... the common law arguably does not go further and allow the court to penalise the fraudulent group member – for example by requiring the genuine parts of the claim also to be forfeited.

- 9.28 Legislation would provide clarity and consistency, and establish beyond doubt that the group member is in the same position as the direct policyholder. Moreover, it would ensure consistency with the pre-contract position. The ABI pointed out:

It makes sense, for consistency with the position pre-contract, that any new legislation regarding the law post-contract directly addresses the fraudulent claims by insured members.

¹¹ See Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation (2010) Law Com Report No 319; Scot Law Com No 219, paras 7.10 to 7.19.

Proposal for reform

- 9.29 We provisionally propose that any statutory reform of the law of fraudulent claims should include special provision to deal with fraud by members of a group scheme. Where a group member acts fraudulently to obtain a benefit under the scheme, the same rules should apply as if a policyholder had made a fraudulent claim. In other words, the member would forfeit the whole benefit, and any subsequent benefit, and would be liable to pay the insurer's reasonable investigation costs. However, the fraud by one or more group members would have no effect on benefits to other members.
- 9.30 **Do consultees agree that a fraudulent act by one or more group members should be treated as if the group member concerned was a party to the contract?**

CHAPTER 3

INSURABLE INTEREST

PART 10

INSURABLE INTEREST: INTRODUCTION

- 10.1 For a contract of insurance to be valid, the insured needs to have an “insurable interest”. At its simplest, this means that someone taking out insurance must stand to gain a benefit from the preservation of the subject matter of the insurance or to suffer a disadvantage should it be lost. Insurable interest acts as the “hallmark” of insurance, distinguishing insurance from gambling.

THE PROBLEMS

- 10.2 Although the principle is simple, the detail is difficult. Professor Merkin has gone so far as to describe the English law of insurable interest as “a confusing and illogical mess”.¹ There are three main reasons for this.

- (1) *The law is a bewildering mixture of common law and statute.* The area is still governed by eighteenth century statutes, notably the Life Assurance Act 1774, while the Marine Insurance Act 1788 may still apply to goods policies. The Marine Insurance (Gambling Policies) Act 1909 creates an unnecessary criminal offence. Furthermore, there is uncertainty over how far the doctrine was affected by the Gaming Act 1845 and its repeal in 2005.
- (2) *The definition of insurable interest is uncertain.* It has been largely left to the courts. In 1806, the House of Lords provided a narrow definition: that the policyholder must have a right in the property, or a right derivable out of some contract about the property.² Since then the definition has been “continuously expanding”,³ as the courts have adapted the doctrine to new forms of insurance. Even within the insurance industry there is no one agreed definition.
- (3) *The doctrine differs depending on the type of insurance.* Discussions of insurable interest typically divide insurance between “indemnity insurance” (such as buildings, goods and liability insurance) and “contingency insurance” (mainly life and personal accident insurance). As we explore below, however, these distinctions are not clear cut. Other distinctions are also important, including the difference between insuring goods, and insurance of “an adventure” involving goods. These distinctions can be subtle and difficult to draw in practice.

- 10.3 Furthermore, in life insurance, the doctrine of insurable interest has been interpreted in a highly restrictive way. The law allows people to insure the life of another on the basis either of “natural affection” or financial loss. Both categories are narrow.

¹ Robert Merkin, *Reforming insurance Law: is there a case for reverse transportation?* A report for the English and Scottish Law Commissions on the Australian experience of insurance law reform (2007) at p 78.

² *Lucena v Craufurd* (1806) 2 Bos & PNR 269.

³ *Moran, Galloway & Co v Uzielli* [1905] 2 KB 555 at 563 by Walton J.

- (1) “Natural affection” permits a person to insure their own life or that of their husband, wife or civil partner,⁴ but, generally, does not allow a person to insure the life of cohabitant⁵, parent or child,⁶ even if they rely on them for economic support. If natural affection is established then the law does not restrict the value of the insurance.
 - (2) For financial loss, the courts require “a pecuniary interest recognised by law”. The proposer must show a legal right to payment, which would cease on death. It is not sufficient to show a reasonable expectation of actual loss. Furthermore, the amount of the cover must reflect the legal right. In strict law, if an employer insures a key employee, the amount should be no more than the loss during the notice period, together with the costs of replacement.
- 10.4 In practice, many policies are written which use a more expansive definition of insurable interest than the case law suggests is permissible. If the matter were to be litigated, it seems likely that the courts would be reluctant to declare the policy void. They would strive to find an insurable interest, and may well expand the categories to fall into line with commercial practice.⁷
- 10.5 Nevertheless, we think it is undesirable to have a mismatch between the law and practice in this way. First, it leads to uncertainty. It also brings the law into disrepute if it is seen to be flouted. Finally, it is possible that some valid and socially useful forms of life and personal accident policies are not being written because of concerns about insurable interest.

CALLS FOR REFORM

- 10.6 The complexity of the doctrine of insurable interest has led to calls for reform. In 2002, the British Insurance Law Association asked us to look at it. In 2006, we consulted on the scope of our insurance law review, and most respondents thought we should include insurable interest. Therefore, in 2008, we published Issues Paper 4 on the subject, seeking views.

⁴ We will use the term “spouse” in the Parts that follow to refer to a husband, wife or civil partner.

⁵ In 1992, in its Report on *Family Law*, Scot Law Com No 135, the Scottish Law Commission recommended that a cohabitant should be given a statutory interest in the life of his or her partner. See Issues Paper 4, para 3.22 and later in this paper at paras 13.92 to 13.94.

⁶ For further details on the eligibility of parents and children to insure each others lives see para 11.73 and following.

⁷ The Scottish courts will entertain an action concerning a policy without insurable interest where the insurer has chosen to honour it. See *Haddon v Bryden* (1899) 1F 710 and *Carmichael v Carmichael’s Executrix* 1919 SC 636. (The latter case was reversed by the House of Lords – see 1920 SC (HL) 195 - although not on the issue of insurable interest.)

INDEMNITY AND CONTINGENCY INSURANCE

10.7 In Issues Paper 4, we looked separately at indemnity insurance and life insurance. Indemnity insurance indemnifies the policyholder for losses suffered; examples include buildings insurance, liability insurance and business interruption insurance. The indemnity principle requires that the insured has suffered a loss in order to recover under the policy. Therefore, the policyholder must have an interest in the subject matter of the insurance or exposure to legal liability for the loss of another to have a valid claim. By contrast, most life insurance is written on a contingency basis, paying a fixed sum on the death of the person insured. Personal accident insurance, which pays a fixed sum for specific injuries, is also contingency insurance.

10.8 The distinction between indemnity insurance and life insurance has become increasingly blurred. In their joint response to Issues Paper 4, Geoffrey Lloyd and Derrick Cole pointed out that some life insurance may compensate for losses:

A life assurance policy is clearly a non-indemnity policy but it can be argued that key-man insurance whereby an employer effects life insurance on the life of a valuable employee is indemnity insurance, especially where the employee's value to the business can be quantified which it often can be.

10.9 Furthermore, some property insurance does more than simply compensate for loss:

Whilst most policies in the general insurance field... are in simple terms referred to as indemnity policies the market has so developed over the last twenty to thirty years that we now have contracts that clearly provide more than indemnity e.g. commercial property covers under the reinstatement conditions that give "new for old"; household policies that give "new for old". "Agreed value" policies are another special category where a claim payment may be a long way from a true indemnity".

10.10 We accept that the division is imprecise. We use it to structure the discussion, but we have tried as far as possible to align the law of insurable interest for both indemnity and contingency insurance.

Reasons for retaining insurable interest

10.11 In Issues Paper 4, we asked whether the doctrine of insurable interest was still necessary for indemnity insurance. We pointed out that indemnity insurance is covered by the indemnity principle, which states that policyholders will only be compensated when they have suffered a loss. We asked for views on whether the doctrine of insurable interest was useful in these circumstances.

10.12 Most of those who responded argued strongly in favour of retaining the requirement for insurable interest, for both life and indemnity insurance. The concept may be difficult to pin down, but it was thought to fulfil four useful functions.

- (1) It provides a dividing line between gambling and insurance. This distinction is crucial for both regulatory and tax purposes, and for those communities where gambling is forbidden. Insurable interest thus is an important part of the definition of insurance.
- (2) It guards against moral hazard. By setting limits on the contracts that insurers may enter into, it protects insurers from themselves – from writing insurance which is overly speculative, or which encourages wrongdoing. In Issues Paper 4, we pointed out that as a protection against murder and arson,⁸ the doctrine of insurable interest often lacks logic. For example, people are much more likely to kill a spouse (whose life can be insured) than an adult descendant (whose life cannot). Nevertheless, respondents still thought that the doctrine was a useful backstop.
- (3) It protects the insurer from invalid claims. In theory, validity is a matter of policy wording: the contract should specify who can claim and in which circumstances. In practice, it is common for the policy to specify the subject matter of the insurance, without tying down the link between it and the insured. This is left to customary understandings, as upheld by court decisions specifying the type of insurable interest necessary for the type of insurance. Insurers feared that radical reform would interfere with these understandings. Claims could be made by a wider class of people, including those without close links to whatever has been insured.
- (4) In an increasingly global market place it is used to define where insurance is located and therefore which regulatory or tax regime it falls within.

10.13 For these reasons, most respondents wished to retain the law of insurable interest. We have listened to these concerns. The proposals we set out in this chapter are therefore measured: we propose to restate the law of insurable interest, with some limited expansion in life insurance.

OUR PROPOSALS

A statutory restatement

10.14 We propose a statutory restatement to confirm that the requirement of insurable interest applies to all forms of insurance. If the requirement is not met the policy would be void. The main difference would be in relation to the time at which the interest must be present. For contingency insurance, where the amount of the payment is set at the time of the contract, the interest would have to be present at the time the contract is made. In other cases, it would be sufficient to have an interest at the time of the loss, although the contract of insurance may provide differently and require that the interest must exist at the outset as well.⁹

⁸ In Scots law, the equivalent of arson is fire-raising.

⁹ Currently, Scots common law requires an insurable interest to be demonstrated in all indemnity insurance contracts at the time the policy is taken out. See Issues Paper 4, paras 5.20 – 5.50.

- 10.15 Two statutes - the Marine Insurance Act 1788 and the Marine Insurance (Gambling Policies) Act 1909 - appear moribund and we propose their repeal.
- 10.16 In relation to indemnity insurance, we ask whether it would be helpful if the current law were to be partially codified by providing a non-exhaustive list of connections which would constitute an insurable interest. The effect of our proposed reform would be to incorporate the two leading authorities on what comprises an insurable interest within a single non-exhaustive statutory definition.¹⁰

Expanding the categories in life insurance

- 10.17 We propose to widen the category of those able to insure the life of another on the basis of financial loss. At present, the law requires “a pecuniary interest recognised by law”.¹¹ There was widespread support for widening the test to one based on a reasonable expectation of economic loss. This test would allow relatives and others to insure the lives of those on whom they are economically dependent. It would also allow employers to insure their key employees for larger amounts.
- 10.18 The new test of economic dependency would mean that there would be less need to widen the categories of “natural affection”, that is, those entitled to insure another person’s life without evidence of loss. We ask about three possible extensions: to children under 18 (and whether only for small amounts); to cohabitants; and to the trustees of pension and other group schemes.

STRUCTURE OF THIS CHAPTER

- 10.19 Part 11 describes the current law. We start with a short history of the tangle of legislation. By and large, the definition of insurable interest has been left to the courts. We look first at how the requirement has been interpreted in indemnity insurance and then at life insurance.
- 10.20 Part 12 looks at insurable interest in indemnity insurance. We analyse the responses we received to Issues Paper 4 and then set out proposals for reform.
- 10.21 Part 13 deals with life insurance. Again, we analyse the responses to Issues Paper 4 and set out proposals for reform.

¹⁰ See para 12.60 and following.

¹¹ In Scotland, “pecuniary interests” are often referred to as “patrimonial interests”.

PART 11

INSURABLE INTEREST: THE CURRENT LAW

- 11.1 The law on insurable interest is complex. Here we start by describing the history of legislation in this area. A succession of moral concerns over gambling in the guise of insurance has led to a legislative tangle.
- 11.2 The following sections look at how the concept has been defined, first for indemnity insurance, and then for life insurance. Generally, the various Acts do not attempt to define insurable interest: this has been left to the courts. For indemnity insurance, the courts have tended towards a wide, open-ended definition. For life insurance, the rules have been interpreted more strictly.
- 11.3 In 2003, the Court of Appeal reviewed the whole area of insurable interest in *Feasey v Sun Life Assurance Co.*¹ The final section examines this case, which highlights that the categories of insurable interest are far from fixed. They are likely to be developed in the future to meet the needs of commercial convenience. A more detailed account of the law can be found in Issues Paper 4, together with the text of the relevant legislation.

THE HISTORY OF LEGISLATION

- 11.4 As we shall see, the statutes on insurable interest are dated, confused and varied. We start with the common law, and then describe the history of statutes from 1745.

The common law

- 11.5 In Scotland, the common law requires an insurable interest for the policyholder to have a valid policy. There must be a “subject in which the insured has an interest”.²
- 11.6 English law is less straightforward: it is not entirely clear whether a requirement of insurable interest exists at common law or whether the doctrine was imposed by statute.³ Although some early cases suggest that insurable interest was needed, by the mid-eighteenth century it was common to use marine and life insurance as a form of gambling. Marine policies were written on the basis that the policy itself was “conclusive proof of interest” (known as “PPI terms”), and the courts were reluctant to override these words.

The Marine Insurance Act 1745

- 11.7 The issue became a public concern, and Parliament intervened. The first legislation to create a requirement of insurable interest was the Marine Insurance Act 1745. Its preamble stated that:

¹ [2003] EWCA Civ 885, [2003] 2 All ER (Comm) 587.

² Bell's Principles, s 457. See also *The Laws of Scotland (Stair Memorial Encyclopaedia)*, Vol 12, para 848 and *Scottish Amicable Heritable Securities Association Ltd v Northern Assurance Co* (1883) 11 R 287 at 303 per Lord Justice-Clerk Moncreiff.

³ We look at this in more detail below: see para 11.30 and following.

It hath been found by experience, that the making of insurances, interest or no interest, or without further proof of interest than the policy, hath been productive of many pernicious practices, whereby great numbers of ships, with their cargoes, have been fraudulently lost or destroyed.⁴

- 11.8 The Act rendered void any marine policy made without interest, or by way of gaming. It also voided marine policies written on PPI terms.

The Life Assurance Act 1774

- 11.9 For the next thirty years, it remained common for policies to be taken out on the lives of public figures – such as George II and Sir Robert Walpole.⁵ Policies were also issued on distant family members and acquaintances. Complaints were made when newspapers started to print the odds of survival of public figures. Many believed that reading the odds hastened the deaths of those who were named.⁶

- 11.10 This led to the Life Assurance Act 1774.⁷ The Act prevents insurance on lives being taken out without a valid interest and declares null and void any contracts of insurance taken without interest. Its preamble states:

Whereas it hath been found by experience that the making of insurances on lives or other events wherein the assured shall have no interest hath introduced a mischievous kind of gaming...

- 11.11 The Act comprises four sections:

- (1) Section 1 bans the making of insurances where there is no interest, and renders any policy issued in such circumstances null and void.
- (2) Section 2 requires the names of those interested to be noted in the policy document. If not, the policy is unlawful.
- (3) Section 3 limits the amount of any recovery to the value of the interest.
- (4) Section 4 provides that the 1774 Act does not apply to "ships, goods, or merchandises".

- 11.12 The 1774 Act is not confined to lives. It also applies to "other events". There was some doubt as to whether the Act extended to insurance on land. In *Siu Yin Kwan v Eastern Insurance Co Ltd*,⁸ however, the Privy Council held that the Act does not apply to indemnity insurance of any kind.

⁴ Preamble to the Marine Insurance Act 1745 the scope of which extended to all of Great Britain.

⁵ Geoffrey Clark, *Betting on Lives* (1999).

⁶ Welford, *Insurance Guide and Handbook* (4th ed 1901) at pp 27 and 28 quoted in *Colinvaux and Merkin's Insurance Contract Law A-0385*.

⁷ Applicable to England & Wales and Scotland.

⁸ [1994] 2 AC 199.

The Marine Insurance Act 1788

11.13 The Marine Insurance Act 1788 followed.⁹ It required the names of those interested in the insurance to be inserted into the policy, to make it easier to check that they had a valid insurable interest.

11.14 Despite its current title, the Act may not be confined to marine insurance. It states that it applies to:

Any Policy or Policies of Assurance upon any Ship or Ships, Vessel or Vessels, or upon any Goods, Merchandizes, Effects, or other Property whatsoever.

11.15 The Act was repealed by the Marine Insurance Act 1906, but only insofar as it affected marine insurance. The Act continues to apply to non-marine insurance on “goods, merchandizes, effects or other property”, although it does not appear to have any practical effects.

The Gaming Act 1845

11.16 The nineteenth century saw a further hardening of attitudes towards gambling. It was said to promote idleness amongst the lower classes and dishonour and suicide amongst the aristocracy. The courts had become reluctant to enforce wagering contracts as they wasted the courts’ time. In 1845 these sentiments led to the passing of a Gaming Act,¹⁰ which held that wagers were unenforceable. A gambling contract is defined as one in which none of the contracting parties has an interest in the subject matter of the contract other than the stake they may win or lose.¹¹ Section 18 of the 1845 Act provided:

All contracts or agreements, whether by parole or in writing, by way of gaming or wagering, shall be null and void; and no suit shall be brought or maintained in any court of law or equity for recovering any sum of money or valuable thing alleged to be won upon any wager.

11.17 As wagers are contracts in which neither party has an interest apart from the contract itself, this section had the effect of making all contracts of insurance unenforceable where no interest could be demonstrated. For general indemnity insurance, therefore, section 18 of the Gaming Act 1845 created an indirect requirement of insurable interest.

The Marine Insurance Act 1906

11.18 The Marine Insurance Act 1906 codified the law at that stage. It repealed the Marine Insurance Act 1745 and the Marine Insurance Act 1788 (in so far as it applied to marine policies on goods), and encapsulated the main case law.

11.19 Section 4 states that:

⁹ Applicable to England & Wales and Scotland.

¹⁰ The Gaming Act 1845 does not apply to Scotland. See *Russell v Grey* (1894) 1 SLT 529 and *Levy v Jackson* (1903) 5 F 1170.

¹¹ *Carlill v Carbolic Smoke Ball Co* [1893] 1 QB 256; see also the first instance decision where there is a fuller consideration of the issue; [1892] 2 QB 484.

- (1) Every contract of marine insurance by way of gaming or wagering is void.
- (2) A contract of marine insurance is deemed to be a gaming or wagering contract -
 - (a) Where the assured has not an insurable interest as defined by this Act, and the contract is entered into with no expectation of acquiring such an interest... .

11.20 Section 5 provides a partial definition of insurable interest. Section 5(1) states that “every person has an insurable interest who is interested in a marine adventure”. Section 5(2) then provides a list of some things that may amount to such an interest:

In particular a person is interested in a marine adventure where he stands in any legal or equitable relation to the adventure or to any insurable property at risk therein, in consequence of which he may benefit by the safety or due arrival of insurable property, or may be prejudiced by its loss, or by damage thereto, or by the detention thereof, or may incur liability in respect thereof.

11.21 This is the only attempt to define insurable interest in statute. There are four points to make about it.

- (1) It only applies to marine insurance. Unlike some other provisions of the 1906 Act, it does not extend to other forms of insurance.
- (2) The definition is non-exhaustive. It states that those who come within the definition have an interest. It does not state that those outside the list fail to have interest.
- (3) It is a broad definition. In *Feasey v Sun Life Assurance Company of Canada*, Lord Justice Waller commented that the words “legal or equitable relation to the adventure” are “intended to be a broad concept”.¹²
- (4) The words “legal or equitable relation” are not apt in relation to Scots law in which the concept of “equitable relation” is unknown. In *Cowan v Jeffrey Associates*, Lord Hamilton recognised this and used English case law to shape his interpretation of this requirement of insurable interest. Having given some examples of insurable interest in Scots law, he added that they were “illustrative of the requirement for a close legal relationship between the person insuring and the property insured”.¹³

11.22 Even in marine insurance, insurable interest is a fluid concept which is difficult to pin down precisely.

¹² [2003] EWCA Civ 885, [2003] 2 All ER 587, at [97].

¹³ 1998 SC 496 at 502.

- 11.23 Section 26 of the 1906 Act states that while “the subject matter insured must be designated with reasonable certainty”, the nature of the insurable interest “need not be specified”. This reflects a long tradition: insurance contracts do not necessarily set out the required relationship between the insured and the subject matter. The insurable interest required by the contract is often left to be inferred from a construction of the contract, from custom and practice and from case law. The effect is that the legal doctrine of insurable interest has a dual outcome; it distinguishes insurance from other risk transfer transactions; it is also used to specify who is entitled to make a claim under any specific form of insurance. We return to this issue in Part 12 when we discuss the purpose of a doctrine of insurable interest.

The Marine Insurance (Gambling Policies) Act 1909

- 11.24 Three years later Parliament considered it necessary to strengthen the sanctions against those who took out marine policies without insurable interest. The Marine Insurance (Gambling Policies) Act 1909¹⁴ made it a criminal offence, punishable by a fine or imprisonment for up to six months.
- 11.25 We have not found any evidence of prosecutions under the Act, which suggests that it has not been used for the purpose for which it was enacted. In any event, a criminal sanction for effecting insurance without interest seems disproportionate and out of place today.

The position in 2005

- 11.26 After 1909, the legislation remained unchanged for nearly one hundred years. By the beginning of the twenty-first century, the requirement for an insurable interest was largely statutory. For marine risks, it was set out in the Marine Insurance Act 1906. For life and other contingent insurance, the Life Assurance Act 1774 provided that insurance made without interest was null and void. For other insurance, the Gaming Act 1845 indirectly required the policyholder to show an insurable interest, as any contract for gaming or wagering was void and unenforceable.

The Gambling Act 2005

- 11.27 Further change was introduced by the Gambling Act 2005.¹⁵ The object of the Act was to regulate certain types of licensed gambling activities¹⁶ and to take account of the internet and new technology.¹⁷ As a result, gambling contracts that related to those activities could be enforced at law, for example allowing consumers to take bookmakers to court to be paid out their winnings.

¹⁴ Applicable in the UK.

¹⁵ Applicable to England & Wales and Scotland (with a restricted application to Northern Ireland).

¹⁶ The 2005 Act defines which gambling activities to which it applies; see, for example, ss 3, 6, 9 and 14.

¹⁷ Government Response to the First Report of the Joint Committee on the Draft Gambling Bill, session 2003-2004, Cm. 6253, June 2004, at p 2.

- 11.28 The Gambling Act 2005 repealed section 18 of the Gaming Act 1845.¹⁸ In its place, the Act states that “the fact that a contract relates to gambling shall not prevent its enforcement”.¹⁹ This provision came into force on 1 September 2007.²⁰
- 11.29 When the Act was passed there was no discussion in Parliament of its effect on insurance contracts. It raises a question which has remained dormant for 160 years: is there a common law requirement that indemnity insurance must have insurable interest? Or was this simply an indirect statutory requirement, which has now been removed?
- 11.30 In Issues Paper 4, we explained that there was a common law requirement in Scotland but the position in England was uncertain. Some early authorities suggest that the courts required interest, including a case from 1692, *Goddard v Garrett*.²¹ In 1743, a case involving fire insurance, *The Sadler’s Company v Badcock*,²² held that the insured party must hold an interest in the insured property both at the outset of the insurance and at the time of the fire. Both cases were subsequently cited by Lord Eldon in *Lucena v Craufurd*.²³ He considered whether the Marine Insurance Act 1745²⁴ was a “legislative declaration that an insurance might have been effected before that statute without interest”.²⁵ Lord Eldon doubted that it was such a declaration, holding instead that the Act precluded the use of particular forms of policy for marine insurance which allowed for the proof of interest to be dispensed with.²⁶
- 11.31 In Issues Paper 4, we speculated that in England, for non-marine indemnity insurance, the only requirement that the insured should have an interest in the insured subject matter may be the indemnity principle itself – namely that the insured must show a genuine loss and therefore an interest in the insured subject matter. We asked whether the 2005 Act had abolished the requirement for insurable interest by the backdoor.
- 11.32 Several consultees argued that the 2005 Act had not abolished the requirement for insurable interest. They pointed out that the 2005 Act was not intended to affect insurance, and did not include insurance within its statutory definitions. As the Lloyd’s Market Association put it:

¹⁸ Gambling Act 2005, s 334(1)(c).

¹⁹ Gambling Act 2005, s 335.

²⁰ SI 2006 No 3272 as amended by SI 2007 No 1157.

²¹ (1692) 2 Vern 269. For further discussion, see Mark Templeman QC, “Insurable Interest: a suitable case for treatment?”, in Dr B Soyer, *Reforming Marine & Commercial Insurance Law*, (2008) at p189.

²² (1743) 2 Atk 554. A case which pre-dates the Marine Insurance Act 1745.

²³ (1806) 2 Bos & PNR 269.

²⁴ Referred to in his opinion as 19 Geo.2.

²⁵ This had been suggested by Lord Kenyon in *Craufurd v Hunter* (1798) 8 TR 13 at p 23.

²⁶ (1806) 2 Bos & PNR 269.

The effect of [the Gambling Act 2005] on insurance contract law seems, to us, theoretical at best, and the Act has no effect, in practice, on commercial or personal insurance business. Statutory definitions of gambling, betting, gaming, games of chance, and participating in lottery are provided in the 2005 Act; none of which refer to contracts of insurance, or seem applicable or relevant to contracts of insurance, which is already regulated by statute, regulation and a wealth of common law.

11.33 Mark Templeman QC made a similar point, arguing that the mischief addressed by the Marine Insurance Act 1906 was not restricted to gambling. A contract void under section 4 is not void merely because it relates to gambling; it is also void for reasons of public policy.²⁷ He thought that the same applied to all insurance.

11.34 Nicholas Legh–Jones QC commented:

I wonder if it is right to say that the Gaming Act [1845] created an obligation for insurable interest in the form developed by the courts. A bona fide expectation of benefit in the preservation of the subject matter would appear to take the insurance outside the scope of section 18, but it would not suffice to establish a valid insurable interest permitting enforcement of the contract.

11.35 That said, the ABI and others thought that the Gambling Act 2005 had introduced unfortunate uncertainty into the law. This view is shared by some academics.²⁸ We agree. In Part 12 we make proposals to clarify that the requirement of insurable interest continues to apply to all insurance.

The timing of the interest

11.36 In life insurance, the Life Assurance Act 1774 does not provide when an interest must exist but case law has established that interest is required at the time of the contract.²⁹ By contrast, section 6 of the Marine Insurance Act states that

The assured must be interested in the subject-matter insured at the time of the loss though he need not be interested when the insurance is effected.

²⁷ Mark Templeman QC, “Insurable Interest: a suitable case for treatment?” see above fn 21, at p195.

²⁸ In *Colinvaux’s Law of Insurance* (8th ed, 2006), at para 4-09, it is stated that the effect of the 2005 Act on insurable interest was “a matter of some difficulty”; this was particularly so with marine policies. *Chitty on Contract* (30th ed 2008), thought it unlikely that the Act affected life or marine policies and it was “questionable” whether making an insurance contract without interest would necessarily come within the meaning of the 2005 Act.

²⁹ See *Dalby v India and London Life Assurance Company* (1854) 15 CB 365. See also *Turnbull & Co v Scottish Provident Institution* (1896) 34 SLR 146 (OH).

- 11.37 For non-marine indemnity insurance, in Scotland the common law requires an interest to be demonstrated at the time the policy is taken out.³⁰ In England and Wales, the law is less clear. Clarke argues that the position is probably the same as for marine insurance.³¹ In Part 12 we propose to clarify this issue.

The consequences of lack of insurable interest

- 11.38 The various statutes provide for different outcomes where the requirement of insurable interest is not satisfied.
- 11.39 The Marine Insurance Act 1906, section 4 provides that, without interest, a contract for marine insurance is void. The 1909 Act, however, goes further and states that the writing of marine insurance without insurable interest is a criminal offence.
- 11.40 For life and contingency insurance, the Life Assurance Act 1774, section 1 provides that policies made without interest are null and void. A later case has held that they will also be illegal.³² As a consequence policyholders cannot claim under their contracts and may not be able to recover the premiums they have paid. In *Feasey*, Lord Justice Ward remarked “why it [the contract] also has to be illegal baffles me”.³³ He suggested that Parliament should look at this point again.
- 11.41 We think that the effect of lack of insurable interest should be the same across the board. In Parts 12 and 13, we propose that the effect of lack of insurable interest should make a contract void. It should not, however, make the contract illegal. Nor should it be a criminal offence.

Conclusion

- 11.42 The statutes on insurable interest are overly complex. The Life Assurance Act 1774 imposes a statutory requirement of insurable interest for life and other contingency insurance. The Marine Insurance Act 1906 imposes a requirement for marine insurance. For other forms of insurance there is probably a common law requirement, but in England and Wales the issue is by no means certain. There are also confusing differences about when the requirement must be satisfied and the effect of a lack of insurable interest on the contract.
- 11.43 Two other statutes remain on the statute book, but now appear moribund: the Marine Insurance Act 1788 and the Marine Insurance (Gambling Policies) Act 1909.

³⁰ See 12 *Stair Memorial Encyclopaedia*, para 856.

³¹ M A Clarke *The Law of Insurance Contracts* (2011) at para 4-4.

³² See *Harse v Pearl Life Assurance Co Ltd* [1904] 1 KB 558.

³³ [2003] EWCA Civ 885, [2003] 2 All ER 587, at [192].

THE DEFINITION IN INDEMNITY INSURANCE

- 11.44 The definition of insurable interest has been largely left to the courts. At first, the courts defined insurable interest narrowly, to focus on property rights. The insured was required to show a legal or equitable interest in the property or a right to it under a contract.³⁴ For the last 200 years, however, the courts have expanded this definition, to meet the needs of a developing insurance market. As an academic commentator remarked:

The English courts seldom shrink from sacrificing doctrine to the practical needs of commerce...³⁵

- 11.45 Where the insurers have written a policy on clear terms, the courts have been extremely reluctant to find that the insurance is invalid for lack of interest. As the Master of the Rolls put it in 1884:

It is the duty of a Court always to lean in favour of an insurable interest, if possible, for it seems to me that after underwriters have received the premium, the objection that there was no insurable interest is often... a technical objection, and one which has no real merit, certainly not as between the assured and the insurer.³⁶

Lucena: the classic definition

- 11.46 The classic definition was set out by the House of Lords in 1806, in the case of *Lucena v Craufurd*.³⁷ Lord Eldon described an insurable interest as:

A right in the property, or a right derivable out of some contract about the property, which in either case may be lost upon some contingency affecting the possession or enjoyment of the party.³⁸

- 11.47 This is a narrow test. The insured must show a legal or equitable interest in the insured property or a right under a contract.³⁹

³⁴ From the opinion of Lord Eldon in *Lucena v Craufurd* (1806) 2 Bos & PNR 269.

³⁵ Chris Nicoll, University of Auckland, *Insurable interest: as intended?* [2008] JBL, 5, 432-447, at p 422.

³⁶ Brett MR in *Stock v Inglis* [1884] 1 QBD 564, at p 571 – quoted by Waller LJ in *Feasey v Sun Life Assurance Co* [2003] EWCA Civ 885, [2003] 2 All ER 587, at [7].

³⁷ (1806) 2 Bos & PNR 269.

³⁸ Above, at [321].

³⁹ In Scots law, the interest must generally be proprietary (including that of a right in security) or one giving either a right to enjoyment of the property in some way or a liability for its loss or destruction, usually under a contract: Gloag & Henderson, *The Law of Scotland*, 12th ed, para 21.04.

11.48 *Lucena v Craufurd* concerned ships that were to be brought into British ports but had been lost during the voyage. Commissioners had been appointed by the King to oversee the venture. The House of Lords sought the advice of the judges⁴⁰ on particular questions of law, one of which one was whether the Commissioners had a sufficient interest in the ships to insure them. One of the judges from whom advice was sought, Mr Justice Lawrence, formulated a broader test. As he put it:

To be interested in the preservation of a thing is to be so circumstanced with respect to it as to have benefit from its existence, prejudice from its destruction.⁴¹

11.49 This test looked not just at the legal relationship between the insured and the property but at likely events. Mr Justice Lawrence stressed that the expectation of benefit or loss must arise “according to the ordinary and probable course of things”. He understood the objection to insuring property in which the insured lacked an interest to be based not on an absence of interest, but on whether the interest the insured did have was such that it was liable to be prejudicially affected by a range of events other than the insured peril. In such a case it would be impossible to say with certainty that the loss was a sufficiently probable outcome on the occurrence of the peril.⁴² The insured would be unable to establish a claim to compensation because he could not show “his loss having clearly arisen from the perils insured against”. Mr Justice Lawrence spoke in terms of the insured having a “moral certainty” of advantage or benefit. In other words, one could not insure a speculative profit, which was unlikely to eventuate.

11.50 Lord Eldon, by contrast, rejected the idea of “moral certainty”, saying that he tried in vain to define a middle category “between a certainty and an expectation”.

11.51 Although Lord Eldon gave the leading opinion in the case, subsequent courts have often referred to Mr Justice Lawrence’s views with approval.⁴³ The courts have inched towards a “factual expectation” test, which now appears to represent the current law.⁴⁴

⁴⁰ That is, the judges of the lower court.

⁴¹ *Lucena v Craufurd* (1806) 2 Bos & PNR 269 at [302].

⁴² For an example of an interest that would not satisfy this test see paras 12.30 and 12.31.

⁴³ See Waller LJ in *Feasey* at [70].

⁴⁴ The test has been adopted and applied in a case of the Canadian Supreme Court, *Constitution Insurance Co of Canada v Kosmopoulos* (1987) 34 DLR 208.

Bailees

- 11.52 One of the earliest extensions was for bailees,⁴⁵ that is, for those who hold other people's goods in their possession, with a duty to take care of them. The courts permitted bailees to insure the goods against all perils, not simply against losses caused by the policyholder's negligence.⁴⁶
- 11.53 An example is a firm of carriers which insures goods in transit. The carrier is entitled to insure for more than their own liability to the owners. Instead, the carrier may insure goods in its possession for their full value against all risks, holding the proceeds in trust for the owner.⁴⁷
- 11.54 This extension was justified on technical grounds: that a bailee had a possessory interest sufficient to recover goods in trover.⁴⁸ The more important reason, however, was that it was commercially convenient. Someone who holds other people's goods is responsible for them in a general sense. It makes commercial sense for them to be able to insure them for their full value, and pass on the proceeds to the owner.⁴⁹

Shareholders

- 11.55 Is a shareholder in a company entitled to insure property owned by the company? This question arose in two cases: *Macaura v Northern Assurance Company Ltd*⁵⁰ and *Wilson v Jones*.⁵¹ The cases are superficially similar, but led to different outcomes.
- 11.56 In *Macaura*, a sole shareholder and main creditor of a company insured timber belonging to the company in his own name. When the timber was destroyed by fire, the insured's claim was rejected on the basis that he held no legal or equitable interest in the insured property. The House of Lords confirmed that a shareholder had no right to insure property owned by a company.⁵²

⁴⁵ In Scots law, there is no direct equivalent of bailment but, for example, in terms of a contract of deposit, a depository is obliged to provide a secure place of custody and to exercise due care to prevent loss of or damage to the property. See Gloag and Henderson, *The Law of Scotland*, (12th Ed, 2007), para 15.06.

⁴⁶ See *Waters v Monarch Fire and Life Assurance Co* (1856) 5 EL & BL 870 and *Dalglish v Buchanan & Co* (1854) 16 D 332.

⁴⁷ *A Tomlinson (Hauliers) Ltd v Hepburn* [1966] AC 451.

⁴⁸ *Waters v Monarch Fire and Life Assurance Co* (1856) 5 EL & BL 870. Trover was an action to recover damages from a person who holds another's goods and refuses to return them. A bailee has no legal entitlement to goods held in this way but is entitled to bring this action. It is superseded by the modern law of conversion.

⁴⁹ See Lloyd J's discussion of this point in *Petrofina (UK) Ltd v Magnaload Ltd* [1984] QB 127 at p 135.

⁵⁰ [1925] AC 619. See also *Arif v Excess Insurance Group* 1987 SLT 473 following *Macaura*.

⁵¹ (1865 - 66) LR 2 EX 139.

⁵² In the Scottish case, *Cowan v Jeffrey Associates* 1998 SC 496, on similar facts, Lord Hamilton (at 503) expressed unhappiness that he could not distinguish *Macaura* in favour of a test based upon factual expectancy.

- 11.57 *Wilson v Jones* also concerned a shareholder who took out insurance on property owned by the company – a telegraph cable. In this case, however, the court allowed his claim. The policy was in a standard form, but included an additional handwritten clause stating that cover extended to every risk and contingency “attending the conveyance and successful laying of the cable”. The court found that the policy was not on the cable but on the shareholder’s interest in the successful completion of the project to lay the cable. Mr Wilson had insured the right thing in the right capacity and was therefore entitled to claim.
- 11.58 These two cases highlight that insurable interest often depends on a careful reading of the contract. Usually, standard insurance on goods is limited to those who have a legal or equitable interest in the goods, or a right to them under a contract. If, however, the insurer was aware of the insured’s circumstances, and wrote the insurance on this basis, the courts will usually extend the notion of insurable interest to cover the circumstances.
- 11.59 The courts will look for ways to find an insurable interest, as is demonstrated by *The Moonacre*.⁵³ Mr Sharp took out insurance on a yacht owned by his company of which he was the sole shareholder. He was given full use of the yacht by two powers of attorney, granted to him by the company. The court found that the right to use the yacht was a valuable benefit, and the power of attorney founded a sufficient legal interest.

“Pervasive interest”

- 11.60 In complex construction sites, standard forms of contract usually require the site owners, contractors and sub-contractors to take out joint insurance on the whole site. In *Petrofina (UK) Ltd v Magnaload Ltd*⁵⁴ the court was asked to analyse the nature of such a contract. Was it a single insurance policy, in which all the parties jointly insured the whole site, or was it a series of smaller policies, in which each party insured its respective interest? The issue mattered in deciding subrogation rights. If the parties were co-insured under a single policy, then they were not entitled to sue each other for their respective losses.
- 11.61 In *Petrofina*, the main contractors took out insurance to cover the construction of an oil refinery extension, in the name of the contractors, sub-contractors and site owners. Sub-contractors supplying heavy lifting equipment dropped a gantry, damaging the work in progress. The insurers then sued the sub-contractors for negligence, in the name of the contractors. The question was whether the sub-contractors had an insurable interest that extended to the whole of the contract works, or whether their interest was limited to the equipment owned by them.

⁵³ [1992] 2 Lloyd’s Rep 501.

⁵⁴ [1984] QB 127.

11.62 After construing the contract, Mr Justice Lloyd held that the sub-contractors were covered in respect of the entire contract works. They had a “pervasive interest”⁵⁵ in the whole site, which included property owned by any other co-insured or for which they were responsible. The judge described the situation as analogous to that of a bailee, even though the sub-contractor is not in possession of the property. The main reason for the decision was that it is commercially convenient to allow all the parties to insure the whole site:

Otherwise each sub-contractor would be compelled to take out his own separate policy. This would mean, at the very least, extra paperwork; at worst it could lead to overlapping claims and cross-claims.⁵⁶

11.63 Subsequent cases have confirmed that contractors and sub-contractors may have a “pervasive interest” in the whole construction site.⁵⁷ Joint insurance of sites is clearly commercially convenient, and has become a common practice. In some cases it is even an industry requirement.⁵⁸

11.64 The courts have, however, sought to limit the concept. It is stressed that the outcome of the case must depend on the construction of the contract.⁵⁹ It has been held that sub-contractors have no “pervasive interest” in the site after the work is completed.⁶⁰ Nor do they have a “pervasive interest” in adjacent property.⁶¹

11.65 For a “pervasive interest” to arise, it is likely that the policyholder needs more than a potential liability for negligence. There may also need to be some element of a joint project, so that all the parties would benefit from the project’s successful completion. In *Deepak*, for example, the court held that the parties had an insurable interest in the construction work because:

they might lose the opportunity to do the work and be remunerated for it if the property were damaged or destroyed.⁶²

⁵⁵ See the decision of the Supreme Court of Canada in *Commonwealth Construction Co Ltd v Imperial Oil Ltd* (1977) 69 DLR (3d) 558 at 560.

⁵⁶ *Petrofina (UK) Ltd v Magnaload Ltd* [1984] Q.B. 127 at p136.

⁵⁷ *Stone Vickers Ltd v Appledore Ferguson Shipbuilders Ltd* [1991] 2 Lloyd’s Rep 288; *National Oilwell (UK) Ltd v Davy Offshore Ltd* [1993] 2 Lloyd’s Rep 582.

⁵⁸ The JCT standard form of contract requires the employer to take out insurance in the name of the employer and contractor for certain risks.

⁵⁹ See *Co-operative Retail Services Ltd v Taylor Young Partnership Ltd* [2002] UKHL 17, [2002] 1 All ER 918, as applied in *Tyco Fire and Integrated Solutions (UK) Ltd v Rolls-Royce Motor Cars Ltd* [2008] EWCA Civ 286, [2008] 2 All ER 584.

⁶⁰ *Deepak Fertilisers and Petrochemical Corporation v ICI Chemicals & Polymers Ltd* [1999] 1 Lloyd’s Rep 387.

⁶¹ *Tyco Fire and Integrated Solutions (UK) Ltd v Rolls-Royce Motor Cars Ltd* [2008] EWCA Civ 286, [2008] 2 All ER 584.

⁶² *Deepak Fertilisers and Petrochemical Corporation v ICI Chemicals & Polymers Ltd* [1999] 1 Lloyd’s Rep 387 at p 399.

11.66 In *Feasey*, however (discussed below), Lord Justice Waller cast doubt on whether there needs to be an additional link between insured and subject matter, other than potential liability.⁶³ The exact boundaries of the concept of “pervasive interest” are far from fixed.

Conclusion

11.67 Insurable interest is interpreted broadly. Where the insurer has deliberately written a policy in respect of the insured’s circumstances, courts will be reluctant to find that the requirement has not been met.

11.68 The issue is one of construction. The court must start by analysing the terms of the contract. Generally, for property insurance, the insured must have a right in the property, or a right derivable out of some contract concerning the property, but this is not a hard and fast rule. Other forms of interest may be sufficient in circumstances where there is a real probability that the insured will suffer a loss or incur a liability on the occurrence of the insured peril.

11.69 Furthermore, as we shall see, the categories of insurable interest are not closed. As insurance products develop to meet consumer demand, new forms of insurable interest may be recognised.

THE DEFINITION IN LIFE INSURANCE

11.70 In life insurance, the courts have interpreted the requirement of insurable interest more restrictively. Although the Life Assurance Act 1774 does not define an insurable interest, subsequent case law and statutes have established three categories. An interest may arise from:

- (1) natural affection;
- (2) a potential financial loss which is recognised by law and can be shown at the time of the contract;
- (3) other statutory provisions.

11.71 Finally, in *Feasey*, the court recognised that there may be forms of insurable interest for group policies which do not fall into any of these three categories.⁶⁴

⁶³ [2003] EWCA Civ 885, [2003] 2 All ER 587, at [95].

⁶⁴ Above at [97].

Natural affection

- 11.72 This enables a person to insure their own life,⁶⁵ or the life of their husband or wife.⁶⁶ Section 253 of the Civil Partnership Act 2004 added civil partners to this category.⁶⁷ The insurance may be for an unlimited amount. The class is extremely limited. In the absence of any pecuniary and legal interest, there is no right to insure the life of a cohabitant.

Parents and children

- 11.73 Similarly, in English law there is no general right for a parent to insure the life of a child. The leading English case is *Halford v Kymer*.⁶⁸ A father took out a policy of life insurance on the life of his son. When the insurance company refused to pay, the father argued that he had an insurable interest because if his son died his chances of receiving care and maintenance would be reduced. The judge stated that, as the parish was bound to maintain him, it was a matter of indifference to the father whether he were maintained by the parish or by his son.
- 11.74 Nor is there a right for an adult child to insure the life of a parent. In the case of *Harse v Pearl Life Assurance Co Ltd*⁶⁹ an adult child insured the life of his mother who cooked and kept house for him. The insurance was said to be for the purpose of funeral expenses. The court found that the policy was void for lack of interest. There was no obligation for a son to incur financial expense in burying his mother (the council would cover such expenses, if necessary) and there was no legal obligation for the mother to keep house for her son.
- 11.75 Although a child who is a minor could suffer a financial detriment on the death of a parent there is no general common law or statutory right in England and Wales for a child to insure the life of a parent. Parents are under an obligation to maintain their children,⁷⁰ and it may be therefore that a child has a sufficient pecuniary interest on which to found an insurable interest in some circumstances.⁷¹

⁶⁵ See *Wainwright v Bland* (1836) 150 ER 334.

⁶⁶ See *Reed v Royal Exchange Assurance* (1795) 170 ER 198 and *Griffiths v Fleming* [1909] 1 KB 805.

⁶⁷ In the paragraphs that follow we use the term “spouse” to refer to a husband, wife or civil partner.

⁶⁸ (1830) 10 B&C 724.

⁶⁹ [1904] 1 KB 558.

⁷⁰ There is no single statutory source for this obligation, because the statutory vehicle for its enforcement varies from context to context. Parents who do not live with their children are liable to make payments calculated under the Child Support Act 1991, while the duty can be seen in more general terms in the Matrimonial Causes Act 1973 and Schedule 1 to the Children Act 1989.

⁷¹ It has been suggested that in principle in England and Wales a child may have an insurable interest in a parent who has been made subject to an order for maintenance; see *MacGillivray on Insurance Law* (11th ed 2008), para 1-101.

11.76 In Scotland, as in England, there is no general right for a parent to insure the life of a child.⁷² Regarding the insurable interest of a child in a parent, however, it has been suggested that, in Scots law, a child is entitled to insure the life of a parent in some circumstances;⁷³ this follows from the obligation of parents to maintain their children (an obligation referred to as “aliment”).⁷⁴ The legal obligation to provide maintenance or aliment may form the basis for a child to have an insurable interest in the life of his or her parents to the value of the obligation. An insurable interest would exist only for as long as the obligation of aliment is owed: it ceases when the child reaches 18 years of age, or 25 years of age if the child is in education or training.⁷⁵

Statutory provisions relating to children

11.77 There is a small exception to the general rule that parents do not have insurable interests in their children’s lives. In reliance on section 99 of the Friendly Societies Act 1992 a parent is able to take out insurance with a friendly society on a child’s life without insurable interest. If that child is under the age of 10, however, the amount recoverable is limited to £800.⁷⁶ The section applies to England, Wales and Scotland.

11.78 Other Acts make it clear that people who stand in the place of parents have no right to insure the lives of the children they look after. For example, the Children Act 1989 and the Foster Children (Scotland) Act 1984 provide that a person who maintains a foster child for reward shall be deemed for the purposes of the Life Assurance Act 1774 to have no interest in the life of that child.

An interest arising out of a financial loss

11.79 It is also permissible to insure the life of another person on the ground that the insured would suffer a loss on the other’s death. Typical examples include:

- (1) A creditor in the life of a debtor, to the amount of the loan.
- (2) A joint debtor in the life of a joint debtor, to the amount of the debt. For example, cohabiting friends buying a house together who are declared to be jointly and severally liable for the mortgage will be able to insure each others’ lives to the amount of the whole of the mortgage debt.

⁷² There is at least one case where an insurance policy taken out by a father on the life of his son (with a provision for the son to take over payment of the premiums at age 21) was upheld despite the lack of insurable interest as the insurance company had chosen to honour it; see *Carmichael v Carmichael’s Executrix* 1919 SC 636. This case was reversed by the House of Lords – see 1920 SC (HL) 195 – although not on the issue of insurable interest.

⁷³ See *MacGillivray on Insurance Law*, (11th ed 2008), para 1-103.

⁷⁴ The Family Law (Scotland) Act 1985, s 1(1) provides that the obligation of aliment is owed by a parent to a child, or to a person accepted as a child of the family. Under s 1(2) the obligation is to provide “such support as is reasonable in the circumstances”.

⁷⁵ Family Law (Scotland) Act 1985, s 1(5) (a) and (b).

⁷⁶ This provision applies in England & Wales and Scotland.

- (3) An employer in the life of an employee, to the value of the period of notice. If the employee is a "key person" it may also be possible to insure the costs of recruiting and training a replacement, and any loss of profits in the meantime.
- 11.80 This category is also extremely limited. The insured must show an interest which is "pecuniary and recognised by law". A "pecuniary interest" is one that is capable of valuation. It must represent an underlying legal obligation, not a voluntary undertaking. Furthermore, section 3 of the Life Assurance Act 1774 limits the sum insured to the economic value of that interest at the time the contract is made and this can lead to practical difficulties. A creditor can insure the life of a debtor but where the loan is not of a fixed term it is not possible to calculate the amount of interest that may become payable over the life of the loan. As a result the sum insured cannot take account of interest that may accrue after the insurance is taken out as this amount is uncertain.
- 11.81 The case of *Hebden v West* illustrates how restrictive the effect of section 3 can be.⁷⁷ A clerk insured his employer's life with two insurance companies for £5,000 and £2,500 respectively. On the employer's death the first insurer paid out £5,000 but the second refused the claim for £2,500, for lack of insurable interest. The clerk had a 7 year fixed term contract of employment at an annual salary of £600. His employer had also lent him £4,700, promising him that he need not repay it while his employer was alive. The court, however, found that only the employment was an interest recognised at law. The promise not to demand the loan was a mere forbearance and not a legally binding promise. As the employee had already recovered to the full extent of his interest in the employment under the first policy (valued at £600 x 7 years), the second policy was void for lack of insurable interest.
- 11.82 Case law has established that employers may insure the lives of employees, but only for a limited amount. In *Simcock v Scottish Imperial Insurance Co*,⁷⁸ the extent of the loss was limited to the value of the employee's services during the time of their notice period. The notice period was the only legally recognised right the employer possessed. The expectation that the employee would stay longer was not sufficient to constitute an insurable interest. We understand that this rule is now widely ignored: key employee insurance is often written for more than the value of the notice period.
- 11.83 In the USA it is sufficient if a beneficiary has "a reasonable expectation of benefit or loss dependent on the duration of a human life".⁷⁹ In the UK this is not enough. As MacGillivray states:

A mere expectancy or hope of future pecuniary benefit from the prolongation of the life insured or of the fulfilment by him of moral obligations owed to the assured, is insufficient to sustain an insurable

⁷⁷ (1863) 3 B&S 579.

⁷⁸ (1902) 10 SLT 286.

⁷⁹ M A Clarke, *The Law of Insurance Contracts* (5th ed 2006), para 3-6B.

interest.⁸⁰

- 11.84 Note that with life insurance, the valuation must be made at the time of the contract, not at the time of death. This creates difficulties for those who are insuring themselves against future uncertainties.

Interest arising out of statutory provisions

- 11.85 In some cases, an insurable interest is created by statute, notably the Local Government Act 1972, the Local Government (Scotland) Act 1973, the Land Drainage Act 1991⁸¹ and the Police (Northern Ireland) Act 2003.
- 11.86 These Acts give local authorities or councils the right to insure the life of members of the authority or the council or the district policing partnership whilst engaged on the business of the authority or council.

THE FEASEY CASE

- 11.87 *Feasey v Sun Life Assurance Co* is a decision of the Court of Appeal, and the most important to consider the test of insurable interest in a modern context.⁸²
- 11.88 The facts are complicated. A protection and indemnity insurance (P&I) club, Steamship Mutual, insured its members against liability claims brought by employees and others who were injured on board their members' vessels. Steamship Mutual approached a Lloyd's syndicate to reinsure the risk, but the syndicate suggested another form of policy, which was more favourably treated under the Lloyd's risk codes. The result was that Steamship Mutual took out a first party personal accident policy, whereby the syndicate agreed to pay a fixed sum to Steamship Mutual for each death or disablement aboard their members' vessels. This in turn was reinsured by Sun Life Assurance Co. Later, when a dispute arose, it was alleged that Steamship Mutual did not have an insurable interest in the lives it had insured.
- 11.89 The case concerned both life insurance and marine insurance, and the judges took the opportunity to re-examine the case law of the last 200 years.
- 11.90 Lord Justice Waller gave the leading majority judgment. He found that Steamship Mutual did have a sufficient insurable interest. He analysed the authorities and placed them into four groups:
- (1) Group 1 is where the court has defined the subject matter as an item of property and the insurance is to recover the value. Here the test is the strict one formulated by Lord Eldon: there must be a legal or equitable interest in the property.
 - (2) Group 2 concerned life insurance. The cases indicated a narrow definition, requiring a legal or pecuniary interest.

⁸⁰ *MacGillivray on Insurance Law* (11th ed 2008), para 1-070.

⁸¹ This Act does not apply to Scotland.

⁸² [2003] EWCA Civ 885 [2003]; 2 All ER (Comm) 587.

- (3) Group 3 is where the subject matter appears to be a particular item of property, but where “properly construed the policy extends beyond that item and embraces such insurable interest as the insured has”.⁸³ This included *Wilson v Jones*,⁸⁴ where the insurance appeared to be on cable, but was in fact on the “adventure” of laying the cable. In these cases, the appropriate test is the “factual expectation test”, first set out by Mr Justice Lawrence, in *Lucena v Craufurd*,⁸⁵ in the ordinary probable course of things, will the insured be deprived of an advantage or suffer a loss?
- (4) Group 4 was even wider. In some cases the courts have recognised interests which are “not even strictly pecuniary” such as policies on the life of a spouse. Lord Justice Waller commented that even in property insurance cases, “something less than a legal or equitable or even a pecuniary interest has been thought to be sufficient”.⁸⁶ For this group, he mentioned *The Moonacre*,⁸⁷ and the cases on “pervasive interest”.

11.91 Lord Justice Waller concluded:

In an insurance of a specific identified life, it will be difficult to establish a legal or equitable relation without a pecuniary liability recognised by law arising on the death of that particular person.

There is however no authority which deals with a policy on many lives and over a substantial period [as was the case with Steamship Mutual] and where it can be seen that a pecuniary liability will arise by reference to those lives and the intention is to cover that legal liability.⁸⁸

11.92 In these cases, he thought that insurable interest should be interpreted broadly, as with the decisions on “pervasive interest”. Here Steamship Mutual had a pecuniary liability in respect of the lives covered, and the intention was to cover that liability. This was sufficient to found an insurable interest.

⁸³ *Feasey v Sun Life Assurance Co of Canada* [2003] EWCA Civ 885, at [87]; [2003] 2 All ER (Comm) 587.

⁸⁴ (1867) LR 2 Exch 139.

⁸⁵ (1806) 2 Bos & PNR 269.

⁸⁶ *Feasey v Sun Life assurance Co of Canada* [2003] EWCA Civ 885, at [90]; [2003] 2 All ER (Comm) 587.

⁸⁷ [1992] 2 Lloyd's Rep 501.

⁸⁸ *Feasey v Sun Life Assurance Co of Canada* [2003] EWCA Civ 885, at [97]; [2003] 2 All ER (Comm) 587.

11.93 Lord Justice Ward gave a dissenting judgment. He concluded, reluctantly, that Steamship Mutual did not have a sufficient insurable interest. He did not accept that the Court of Appeal could ignore two House of Lords decisions, in *Lucena*⁸⁹ and *Macaura*,⁹⁰ that there must be a legal or equitable relationship between the insured and the subject matter of the insurance. It was not possible to ignore this requirement simply because it would be commercially convenient to do so. This, he thought, was a matter for Parliament or the House of Lords (now the Supreme Court).

CONCLUSION

11.94 By its nature, insurable interest is a fluid concept, which is difficult to pin down. Even so, the law on insurable interest is more complicated than it needs to be. The legislation is confused, leaving some room for doubt over whether a requirement of insurable interest exists for all forms of insurance. Two statutes appear moribund.

11.95 For indemnity insurance, the courts have interpreted the requirement of insurable interest in a flexible, open-ended way. In life insurance, however, the categories are more restricted. The law does not generally allow cohabitants, parents or children to insure each other's lives, even if they rely on each other for economic support.

11.96 In life insurance, to found an interest based on financial loss, the case law requires "a pecuniary interest recognised by law": the policyholder must have a legal right to payment, not a reasonable expectation of loss in fact. The problem is compounded by the fact that the amount of the payment must reflect the legal right. For example, in strict law, if an employer insures a key employee, the amount should be no more than the loss during the notice period, together with the costs of replacement.

11.97 Recently, the Court of Appeal has recognised that insurable interest is an open-ended test. For insurance on many lives over a substantial period, a more fluid test may be applied. It is unclear, however, how far this extends.

11.98 In Part 13 we propose a measured extension of insurable interest in life insurance. This would bring the law into line with current practice, allow some small increase in the insurance that may be written, and provide greater clarity to the law.

⁸⁹ (1806) 2 Bos & PNR 269.

⁹⁰ [1925] AC 619.

PART 12

INDEMNITY INSURANCE

- 12.1 In this Part, we consider the insurable interest in indemnity insurance, where (unlike life insurance) the policyholder is indemnified against a loss. We start by analysing the responses we received to the Issues Paper, focusing on the reasons why consultees wished to retain the requirement of insurable interest in indemnity insurance. We then set out our proposals for reform.

CONSULTEES' VIEWS

Should insurable interest be retained?

- 12.2 In Issues Paper 4, we sought views on whether there was a need to retain the requirement for insurable interest in indemnity insurance. We pointed out that indemnity insurance is subject to the indemnity principle. To recover, the insured must have suffered a loss, and to have suffered a loss, the insured must have an interest in the subject matter of the insurance. We argued that it was difficult to see what the requirement of insurable interest added to the common law principle of indemnity.¹
- 12.3 Many respondents argued strongly that the requirement of insurable interest should be retained. Of the 15 consultees who expressed a view, only two supported the removal of the requirement in indemnity insurance and the remainder either argued for its retention on a number of grounds or queried the suitability of the indemnity principle as a substitute.
- 12.4 It was said that the indemnity principle focused on a different issue: it looked at whether there was a loss. As Nicholas Legh-Jones QC commented, this was different from insurable interest, which considered the relationship of the insured to the subject matter of the contract.
- 12.5 The requirement of insurable interest was thought to be important for three main reasons: it was the hallmark of insurance; it reinforced market discipline; and it acted as a barrier against invalid claims. The concept of insurable interest may also be useful in other circumstances, such as specifying the location of insurance. Below we look at each of these reasons in turn. Finally, respondents felt that major reform of insurable interest was not a priority. It was potentially disruptive, without providing clear benefits.

The hallmark of insurance

- 12.6 Several respondents argued that insurable interest was part of the definition of insurance. Thus the Association of British Insurers (ABI) argued that the requirement should be retained “on the basis that it delineates the general boundary within which the insurance industry operates”. This boundary was important for purposes of regulation, tax and legal purposes. As the City of London Law Society put it, the requirement serves “useful functions in relation to both the contractual and regulatory aspects of insurance law”.

¹ Issues Paper 4, para 7.34 and following.

- 12.7 The current governing legislation for insurance is the Financial Services and Markets Act 2000 which regulates the “effecting and carrying out [of] contracts of insurance” which is classified as a regulated activity. Section 19 of the 2000 Act imposes a general prohibition on carrying out a regulated activity in the UK unless the person doing so is authorised under the Act or otherwise exempted by the Act.
- 12.8 A contract of insurance is defined in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001. The definition does not define insurance as such but merely lists those contracts that are deemed to be contracts of insurance. It does not follow, therefore, that simply because an insurer authorised under the Act writes a contract it will automatically be a contract of insurance; the test of whether it is or not is external to the provisions of the Act.
- 12.9 The International Swaps and Derivatives Association was keen to retain a clear distinction between insurance and derivatives contracts. It expressed concern that any reform should not:
- impact the boundary between contracts of insurance and derivative contracts unless part of the reform is to clearly recognise in English law the non-insurance character of derivatives.
- 12.10 The Lloyd’s Market Association pointed out that “many contracts issued by Lloyd’s are based on foreign law, nearly all of which often require insurable interest”. Some foreign regulators require insurable interest. They expressed concern that removing the need for insurable interest would make English-law based contracts less competitive.
- 12.11 It was said that insurable interest was important to stress to the world that there was a clear difference between insurance and gambling. The ABI thought that the “absence of insurable interest would increase the potential for fraud and the risk of undesirable consequences” such as gambling on the lives of strangers.
- 12.12 Furthermore, in some circumstances insurance is compulsory.² This might cause problems for those whose morality does not allow them to gamble, if the distinction between gambling and insurance is not maintained. For example, under Islamic (Shari’a) law, insurance is acceptable and operates through the takaful system. The arrangement should be free from any element of gambling, which is strictly prohibited.³ The requirement for insurable interest ensures this clear separation.

² For example under the Road Traffic Act 1988 and the Employers’ Liability (Compulsory Insurance) Act 1969.

³ However, there is a divergence of views on whether insurance is permitted and some Shari’a scholars consider any insurance Haram (forbidden) as a form of gambling or because it is uncertain whether the policy will ever pay out and this ambiguity is not permitted (Gharar or uncertain). Others consider that where insurance is required by law and the subject matter is legitimate, as in car insurance, then the law must be followed and the insured is excused. We are indebted to Dr Ludwig Stiffl, Head of the Centre of Competence Retakaful, Munich Re.

Market discipline

- 12.13 The ABI remarked that the requirement of insurable interest “reinforces market discipline”. Aviva also thought that the requirement for insurable interest reduced moral hazard and ensured “efficient underwriting procedures”.
- 12.14 In Issues Paper 4, we expressed doubt about how far the requirement of insurable interest actually constrains the market. It is easy for an insurer to waive the requirement in specific cases. And on those rare occasions when the point comes before a court, the courts are naturally reluctant to allow the insurer to refuse a claim on the ground that the insurer should not have entered into the contract. Nevertheless, insurers felt that the doctrine of insurable interest has some underlying psychological effect in constraining the policies they were prepared to write.
- 12.15 Issues Paper 4 pre-dated the financial crisis of 2008. One of the alleged causes of the crisis was the involvement of banks and investors in financial instruments, such as swap and derivative contracts, which did not require the parties to show a direct interest in the trigger events. It is possible that the requirement of insurable interest may have been one factor restraining the insurance industry from entering into speculative forms of trading. If so, there would appear to be merit in retaining the requirement of insurable interest.

A barrier against invalid claims

- 12.16 Insurers regarded insurable interest as a “useful tool in declining invalid claims”. The Lloyd’s Market Association put this point in the following terms:

We are concerned that if the requirement to demonstrate an interest in the policy is removed, the effect will be to encourage (spurious) claims by 3rd parties unrelated to the policy – particularly in cases where the 3rd party has suffered a demonstrable loss. Currently such claims are fairly rare given the significant barrier that insurable interest (or lack of) presents to fraudsters and vexatious claimants... .

Insurable interest is a useful tool in declining invalid claims which can be objectively tested. The alternative would be to prove misrepresentation; there would be more scope for costly disputes. Without this, you would be obliged to rely on proving misrepresentation – a far more subjective exercise – meaning more scope for disputes and consequent increased costs and unnecessary court time.⁴

⁴ The LMA also provided anecdotal evidence of the effect in Australia of the abolition of insurable interest; it had led to an increase in fraudulent claims and a higher level of out of court settlements in non-marine business; teething litigation still continued in some areas and more fraudulent/frivolous claims were being paid or settled due to the difficulty of proving fraud.

12.17 We doubt that the general requirement for insurable interest places much constraint on invalid claims. As we have seen, however, specific types of contracts assume that the claimant will possess a specific, limited form of insurable interest. For example, under a standard marine insurance policy on goods, the benefit may be assigned, but claims may only be brought by those to whom risk has passed under a contract of sale.

12.18 Royal & Sun Alliance (RSA) commented that for marine goods contracts, the test of insurable interest under the Marine Insurance Act 1906 operated satisfactorily:

International trade requires clarification of who has insurable interest such as the MIA provides, where goods may change hands many times before reaching final destination. If there was no requirement for insurable interest it is conceivable that underwriters could find themselves facing credit loss claims from multiple parties to the transaction.

12.19 We accept that for certain types of contract, insurable interest has a limited specific meaning, and these meanings could be disturbed by major reform. Therefore, we do not propose that there should be any reform of the statutory requirement for insurable interest imposed by the Marine Insurance Act 1906 or its meaning.

Other uses of insurable interest

12.20 We were told that the concept of insurable interest may have other uses. It may, for example, help define where insurance is located. This is increasingly important for tax and regulatory purposes, especially in jurisdictions which require the insurer to be registered in that jurisdiction.

12.21 A recent paper highlights the utility of insurable interest in these circumstances.⁵ The authors examine the case of a multinational parent company wishing to obtain consistent worldwide cover for its subsidiaries. It takes out a master policy, with broadform named insured clauses, to enable a subsidiary to claim against the master policy for loss not covered by its own local policy. In some jurisdictions local regulators might consider the insurer under the master policy to be improperly conducting business in that jurisdiction by directly insuring those risks.⁶ The authors considered that a prudent solution would be to “rely upon the basic legal concepts of insurable interest”. Thus subsidiaries should be removed from the master policy. Instead the policy should clearly identify the parent company’s insurable interest, which is to indemnify the subsidiary in cases of loss.⁷

No significant benefits from abolishing the requirement

12.22 Finally, consultees thought that reform as we had tentatively proposed in Issues Paper 4 would have a disruptive effect, and bring few benefits. The ABI urged caution “given there are few obvious benefits to customers and the industry”. Martin Mankabady of Lawrence Graham LLP considered that the abolition of insurable interest would be unlikely to trigger significant benefits; therefore its removal was not a priority. Geoffrey Lloyd and Derrick Cole noted that the requirement for insurable interest caused little practical difficulty and was not an onerous responsibility on insurers.

12.23 Mark Templeman QC put this point in the following terms:

Few would disagree with the proposition that the law on insurable interest in indemnity insurance is uncertain. And it may be that the law merits reform for that reason alone. But if lack of clarity is the driver for reform, it may be necessary to proceed with caution.

For the most part, the law in relation to insurable interest does not produce injustice. That is not to say that it never does so: on occasion it has, and no doubt (if unreformed), it will continue, on occasion to do so. But it is not a major source of injustice.⁸

⁵ *Structuring Multinational Insurance Programmes: Current Challenges in Australia, New Zealand and the Asia- Pacific Region*, Suresh Krishnan and Brendan Hammond, ACE Progress Report, (May 2011).

⁶ It would be improper for being non admitted insurance.

⁷ See further, Suresh Krishnan, *Beyond “Non-Admitted”: A Closer Look at Trends Affecting Today’s Multinational Insurance Programs*, ACE Progress Report, (April 2010); Suresh Krishnan and Denis Whelan, *Structuring Multinational Insurance Programmes: Addressing the Current Challenges in Europe*, ACE Progress Report, (August 2010); *Structuring Multinational Insurances Programs: Insights into Cross-Border Insurance Regulation in Canada*, Suresh Krishnan and Fernand Vartanian, (Nov 2011). We are indebted to Mr Suresh Krishnan for his assistance.

⁸ Mark Templeman QC, “Insurable Interest: a suitable case for treatment?” in Dr B Soyer, *Reforming Marine & Commercial Insurance Law*, (2008) at p 202. However, it should be noted that overall the author considered that so far as indemnity insurance was concerned “there is simply no need for a separate concept of insurable interest”.

- 12.24 He explained that there are two reasons for this. First, the courts lean against finding lack of insurable interest. Secondly (and more significantly), insurers are loath to take the point.
- 12.25 We accept that removing the requirement of insurable interest would be disruptive. Without a compelling reason for such major reform, we should proceed with caution. On the other hand, the uncertainty and complexity generated by the patchwork of statutes and case law as to how and when a requirement is imposed is a defect in the current law that we think should be addressed.

Is the current definition of insurable interest satisfactory?

- 12.26 If the requirement of insurable interest is to be retained, the next issue is what, if anything, needs to be done in relation to any definition of what comprises a valid interest as determined by the case law. The definition of insurable interest in indemnity insurance did not appear to be a major concern for most insurers. The ABI commented that:

Insurers are currently able to write policies that are required by customers and the issue of insurable interest is rarely raised at the claims stage. There is no significant customer problem or market opportunity creating an imperative for legislative change.

- 12.27 On the other hand, a few respondents argued that the definition should be expanded. Adrian Hamilton QC continued to support an earlier recommendation made by the British Insurance Law Association (BILA) in their 2002 Report.⁹ He said that:

If insurable interest is to be retained... it should be changed to a test of "insurable relationship" so that economic disadvantage is the test, not legal or equitable interest in the subject matter of the insurance.... The problems under the present law arise because of the highly technical rules governing our current law of insurable interest. So I am clear that some change in the law is desirable.

- 12.28 The International Underwriting Association also supported the BILA recommendation and argued that there should be an economic disadvantage element in insurable interest.
- 12.29 We think that the courts have already moved in this direction, and now accept the wider test, as set out by Mr Justice Lawrence in 1806.
- 12.30 Geoffrey Lloyd and Derrick Cole, on the other hand, thought that we should go further than the current law. They suggested that it should be possible to insure a mere expectation. They gave an example of a nephew who is made an oral promise by his uncle that he will inherit his house. The uncle does not insure the property. They argue that the nephew should be entitled to insure the property.

⁹ *Insurance Contract Law Reform, Recommendations to the Law Commission: a report of the sub-committee of the British Insurance Law Association*, 1 September 2002, at para 24.

12.31 We consider that this goes too far. The nephew has nothing more than a mere expectation of inheriting the property (a *spes* or hope).¹⁰ In the words of Mr Justice Lawrence, this is “so uncertain” that it “may not be the subject matter of insurance”. It could be defeated by a range of events other than the insured peril. The uncle could make a valid will leaving the property to someone else; or choose to sell the property; or become insolvent. At present, this would not be recognised as an insurable interest. Nor should it be. We think that it stretches the concept too far.¹¹

Should insurers check expected loss?

12.32 Finally, in Issues Paper 4, we asked whether insurers should be obliged to check that policyholders have an expectation of loss at the outset of the contract.¹² We were concerned that policyholders might take out cover, and pay for it over a period of time only to find when they came to claim that the policy was void.

12.33 Most consultees argued against such a requirement. Out of 13 responses, 9 expressed the view that there should not be a requirement. The ABI spoke for most insurers in arguing that any problems should be addressed by Financial Services Authority regulation and the Treating Customers Fairly principle. We agree that this is not an appropriate issue for primary legislation, and we do not propose to take the issue further.

Conclusion

12.34 We accept the arguments that have been put to us in favour of retaining insurable interest in indemnity insurance. It is integral to the definition of insurance and to the way in which policies are written. Any major reform would be disruptive, for no clear benefit.

12.35 Thus we have been measured in our approach. Our provisional proposals are aimed at providing a single, easily identifiable statutory source for the imposition of the requirement and spell out the consequences of non-compliance, untangling over 200 years of legislation. For indemnity insurance, we do not propose to change in substance what comprises an insurable interest in the current law, as set out in the cases outlined in Part 11. Although, as will be seen below, we consider whether the definition should also be put on a statutory footing.

¹⁰ See *Colinvaux & Merkin's Insurance Contract Law* (May 2011), para A-0402.

¹¹ Under current law, in Scotland if the uncle's promise to the nephew was made in writing, it would confer a binding personal right affecting the estate, which might suffice to create an insurable interest. Under English law, a written promise might confer a contractual right or evidence a beneficial interest in the property.

¹² Issues Paper 4 at para 7.54.

PROPOSALS FOR REFORM

- 12.36 In Part 11, we described the many statutes which regulate this area. They are dated, inconsistent and uncertain. Marine insurance is governed by the Marine Insurance Act 1906 and the Marine Insurance (Gambling Policies) Act 1909. Life insurance and other contingency insurance are regulated by the Life Assurance Act 1774. For most indemnity insurance, the basis of the requirement for insurable interest is uncertain.¹³
- 12.37 Under the Marine Insurance Act 1906, insurance made without interest is void. Under the 1909 Act, it is a criminal offence. The Life Assurance Act 1774 provides that policies made without interest are null and void, but case law has held that they are also illegal.¹⁴
- 12.38 We propose that the requirement of insurable interest should be imposed by statute alone. The statute should clarify that the requirement for insurable interest exists in all forms of insurance (including indemnity insurance). In indemnity insurance, to make a claim, the insured must show insurable interest at the time of the loss. We also propose that unless there is a real probability that a party would acquire some form of insurable interest at some stage, an insurance contract should be treated as void: the insurer may not sue for the premium, and the insured is entitled to a refund of premiums already paid. This is to guard against an insured being sold a policy that is, to all intents and purposes, worthless.
- 12.39 There should be no statutory requirement to check insurable interest or to insert the names of those interested in the insurance into the policy. We therefore propose to repeal the Marine Insurance Act 1788, which still appears to apply to non-marine insurance on goods.
- 12.40 As far as the definition of insurable interest is concerned, we welcome views on two possible options:
- (1) Option 1 would not define what comprises a valid insurable interest for the purposes of indemnity insurance. Instead the matter would be left entirely to the courts, as it is now.
 - (2) Option 2 would provide a partial codification of the common law, in much the same way as the Marine Insurance Act 1906. It would provide a non-exhaustive list of what does constitute insurable interest, while recognising that the concept is open-ended. The courts may develop it further as time goes on.

Proposal 1: A statutory base for insurable interest

- 12.41 In Part 2 of the Issues Paper, we highlighted the uncertainty in English law over the legal basis of the requirement of insurable interest, now that gambling contracts have been made enforceable. Many respondents agreed that this uncertainty is undesirable. We propose to enact a requirement that the insured must have an insurable interest in the subject of the insurance.

¹³ Although it remains a common law requirement in Scots law.

¹⁴ See *Harse v Pearl Life Assurance Co Ltd* [1904] 1 KB 558.

- 12.42 **Do consultees agree that there should be a statutory requirement that an insured has an insurable interest in the subject matter of the insurance?**

Proposal 2: Timing and consequences

- 12.43 In some cases, the policyholder may possess an insurable interest at some time during the insurance period, but not at other times; as we have explained though, in order to make a claim the insured must have an interest at the time of loss. The following example provides an illustration:

In January a second-hand car dealer enters into a year's contract to insure a garage which it intends to buy in February. The purchase is delayed until 31 March. From 1 April to 31 October, the policyholder owns the garage, but sells it again on 1 November.¹⁵

- 12.44 There are two main questions: may the policyholder claim for a loss, and may the insurer sue for the premium? We explore these below.

Making a claim: insurable interest at time of loss

- 12.45 In deciding whether the policyholder may make a claim, the crucial issue is the time of loss. If the insured did not possess an insurable interest at the time of the loss, it may not make a claim. In this example, suppose that the garage suffers minor storm damage on 1 February, but the dealer decides to go ahead with the purchase regardless. It may not claim for this damage, as it did not have an insurable interest at the relevant time. But the contract is not void: on 1 April the sale was completed, and the insurance operated satisfactorily for seven months. If the property burnt to the ground in June, the policyholder would be entitled to claim.

Premiums must be paid unless the contract is void

- 12.46 The next question is whether the insurer should be entitled to sue for the premium. In our view, the insurer should be entitled to sue for the premium under the contract unless the contract is void. Furthermore, we think that the contract should only be considered void for lack of insurable interest if there was never a real probability that the policyholder (or any other party) would acquire an insurable interest at any stage during the life of the contract. In these circumstances, the policy is effectively worthless.
- 12.47 In this example, we think that the insurable interest from April to October is sufficient to make the contract a valid one, for which premium is due. Whilst it is true that the insured only obtained seven months of benefit out of a twelve month contract, this was the risk that the insured took in organising insurance in advance.

¹⁵ It is not uncommon in commercial insurance for policyholders to have a block policy to which risks are attached as property or items are required. The extent and nature of the policyholder's insurable interest will therefore vary over the policy term.

12.48 We have also considered the appropriate outcome where the insured might have obtained an insurable interest but did not do so. Suppose, in this example, that the dealer went into liquidation in February, and never bought the garage. Again, we do not think that the contract is void for lack of insurable interest. This is because there was a real probability that an insurable interest might have been acquired. Again, the insured took the risk that the sale might fall through. As far as the doctrine of insurable interest is concerned, the insurer is entitled to retain the premium (though the contract may provide for other cancellation rights).

12.49 This contrasts with a case in which there was never any real probability of insurable interest. For example, if a gambler took out insurance against the collapse of the Eiffel Tower, without any intention of acquiring an interest in the Eiffel Tower, the whole contract would be void for lack of insurable interest. Not only would the policyholder be unable to make a claim, but the insurer could not sue for the premium. We propose that an insured who had already paid the premium, and who could prove that the contract was void for lack of insurable interest, would be entitled to the return of premiums paid.

12.50 **Do consultees agree that:**

- (1) **to make a claim, the insured must show insurable interest at the time of the loss?**
- (2) **an insurance contract is void for lack of insurable interest unless there is a real probability that a party would acquire some form of insurable interest at some stage during the life of the contract?**
- (3) **if the insured shows that the contract was void for lack of insurable interest, the insurer may not sue for premium, and the insured is entitled to a refund of premiums already paid?**

Proposal 3: Repealing the Marine Insurance (Gambling Policies) Act 1909

12.51 This Act makes it a criminal offence to effect a contract of marine insurance without having a bona fide interest. Section 1 imposes criminal liability on the policyholder. The person effecting the insurance may, on summary conviction, be liable to a fine or imprisonment for up to six months. Subsection 2 states the broker and insurer are also guilty of the offence, and liable to the same penalties. The full text of the Act is available in Issues Paper 4, Appendix C.

12.52 We have not found any evidence of prosecutions under the Act. We do not think it is necessary to impose criminal liability, as any problems in the market are subject to financial services regulation. Furthermore, it is clearly undesirable to retain criminal penalties that are unnecessary and unused. We propose to repeal the Marine Insurance (Gambling Policies) Act 1909 in its entirety.

12.53 **Do consultees agree that the Marine Insurance (Gambling Policies) Act 1909 should be repealed?**

Proposal 4: Repealing the Marine Insurance Act 1788

- 12.54 The Marine Insurance Act 1788 requires the names of those interested in the insurance to be inserted into the policy.¹⁶
- 12.55 The Act was repealed by the Marine Insurance Act 1906, but only insofar as it affected marine insurance. It appears that the Act continues to apply to non-marine insurance on “goods, merchandizes, effects or other property”. The Act appears to be widely ignored and seems unnecessary. We propose to repeal the Act in its entirety.
- 12.56 **Do consultees agree that the Marine Insurance Act 1788 should be repealed?**

Proposal 5: Retaining the provisions on insurable interest in the Marine Insurance Act 1906

- 12.57 The Marine Insurance Act 1906 sections 4 to 15 govern the requirement for insurable interest for insurance contracts that fall within the ambit of the Act. As discussed in Part 11, section 5 provides a partial, non-exhaustive definition of insurable interest:¹⁷
- (1) Section 5(1) sets out the general principle: “every person has an insurable interest who is interested in a marine adventure”.
 - (2) Section 5(2) states that “in particular” certain relationships count as being interested in a marine adventure. This includes, but is not limited to, a legal or equitable relation to any insurable property at risk in the adventure.¹⁸
- 12.58 We do not intend that sections 4 to 15 of the 1906 Act should be affected by our proposed reform. We have been told that they operate well.
- 12.59 **Do consultees agree that, for marine insurance, sections 4 to 15 of the Marine Insurance Act 1906 should be left as they are?**

Proposal 6: Defining insurable interest - two options

- 12.60 The question is whether to provide a similar non-exhaustive list for non-marine indemnity insurance. The alternative would be to impose a requirement of insurable interest by statute but leave the meaning of insurable interest entirely to the courts.
- 12.61 We have analysed the main cases on insurable interest, to consider what a partial definition would look like. There are three main elements:

¹⁶ The full text of the Act is available in Issues Paper 4, Appendix C.

¹⁷ See para 11.20 and following.

¹⁸ This is based on the classic definition of insurable interest as set out in *Lucena v Craufurd* (1806) 2 Bos & PNR 269; see also para 11.46 and following.

- (1) The insured has a right in the property which is the subject of the insurance or a right arising out of a contract in respect of it. This is the classic test, as set out in *Lucena v Craufurd*.¹⁹
- (2) A factual expectation, either of an economic benefit from the preservation of the insured subject matter, or of an economic loss on its destruction, which would arise in the ordinary and probable course of things. This is the test proposed by Mr Justice Lawrence in *Lucena v Craufurd*, which has since been approved by the Court of Appeal in *Feasey*.²⁰
- (3) Where the insured has possession of the insured subject matter. This would provide for cases concerning bailees, such as carriers of goods.²¹ The courts have held that bailees may insure not just their liability to the property owner but the whole extent of the property. Any sum recovered in excess of the bailee's immediate loss or liability is held on trust for the owner.

12.62 This list does not attempt to codify the nature of a sub-contractor's "pervasive interest" in a construction project. The law in this area is still developing and we think it should be left to the courts. The list does, however, answer Lord Justice Ward's criticism that the factual expectation test is inconsistent with two House of Lords decisions (in 1809 and 1925) and has no basis in law.

12.63 In Part 11, we noted Lord Justice Waller's reminder that the categories of insurable interest are not closed. In some cases, something less than a pecuniary interest may suffice. We think that this flexibility is needed to cover new forms of insurance as they develop, and it is important to retain it within the statutory definition.

12.64 This can be illustrated with an example. In Issues Paper 4, we set out a series of scenarios and invited consultees' comments. One concerned an oil company operating in a country where there was a strong presumption that anyone who pollutes would make a donation to the local community.²² Most consultees said that this would be binding in honour only, and it was highly unlikely they would offer cover, but one or two thought they might consider offering cover if that was how business was conducted locally. This illustrates how the meaning of insurable interest may develop in the future. It is difficult to predict the new demands for insurance, and we think that the full definition of insurable interest should remain flexible.

12.65 We welcome comments on these two options, and on the proposed list.

12.66 **Should the statute state that an insured has an insurable interest if the insured has:**

- (1) a right in the property which is the subject matter of the insurance or a right arising out of a contract in respect of it;**

¹⁹ (1806) 2 Bos & PNR 269.

²⁰ [2003] EWCA Civ 885 [2003] 2 All ER (Comm) 587.

²¹ See para 11.52 and following.

(2) a real probability either of an economic benefit from the preservation of the insured subject matter, or of an economic loss on its destruction, which would arise in the ordinary course of things; or

(3) possession of the insured subject matter?

12.67 Should other forms of insurable interest be included in the list?

12.68 Should the list be non-exhaustive?

12.69 Alternatively, should the definition of insurable interest be left entirely to the courts?

²² Issues Paper 4 at para 5.47.

PART 13

LIFE INSURANCE

INTRODUCTION

- 13.1 Here we consider how insurable interest should be defined for life insurance. Along with life insurance, we also consider personal accident and critical illness insurance written on a contingency basis, for a set amount.
- 13.2 As we saw in Part 11, the current law is restrictive. It does not allow people to insure the life of a cohabitant or a child, and insurance on “key employees” is limited to the notice period. It is common for life insurance policies to go beyond the technical limitations of the current case law. Insurers frequently write “key employee” insurance for sums which exceed the notice period. Furthermore, travel insurance often includes a fixed sum on the death or injury of a child. As noted in a leading textbook, this is a time when “insurance practice is becoming increasingly impatient” with the restrictions imposed by the “rigidity and historical emphasis in the English law rules of insurable interest”.¹
- 13.3 In Issues Paper 4, we asked if the requirement of insurable interest should be retained for life insurance. If it is to be retained, we proposed that it should be expanded.
- 13.4 We identified the following problems:
- (1) The law allows people to insure their own life and that of their spouse² for an unlimited amount. This is said to be based on “natural affection”. However, this class is limited. One cannot insure the life of a cohabitant, a child or sibling. We asked whether the category of natural affection should be expanded, to recognise a wider class of relationships.
 - (2) Many policies are based on the fact that the insured will suffer a financial loss on another’s death. This category is restricted in two ways:
 - (a) It only covers “a pecuniary loss recognised by law”. The proposer must have a legal right to payment: thus a binding agreement to pay an allowance would be sufficient, but not an informal understanding. We tentatively proposed that the test should be relaxed, to cover a reasonable expectation of economic loss.
 - (b) Under section 3 of the Life Assurance Act 1774, any recovery is limited to the value of the insurable interest at the time of the contract. Yet the extent of the loss may vary over time. We asked if this test should also be relaxed.
 - (3) The basis of insurable interest in group policies is uncertain. We asked if special rules should be provided to cover this form of insurance.

¹ *MacGillivray on Insurance Law*, (2008 11th ed), para 1-049.

² The term “spouse” refers to a husband, wife or civil partner.

- 13.5 Here we start with a summary of consultees' views on these issues. We then set out our proposals for reform.

CONSULTEES' VIEWS

Should insurable interest be retained for contingency insurance?

- 13.6 In Part 12, we explained that there was strong support for retaining a requirement of insurable interest in indemnity insurance. The same is true for contingency insurance. Of the 19 responses we received, 17 said that the requirement should be retained.
- 13.7 The reasons given were similar to those in respect of indemnity insurance. Insurable interest was thought to be the hallmark of insurance, distinguishing insurance from gambling. It ensured market discipline, reduced moral hazard and deterred invalid claims. Concern about moral hazard was a particular factor in life insurance, especially when insurance was taken out on the lives of vulnerable people such as young children or the elderly.

Natural affection: should the categories be expanded?

- 13.8 The law has not kept pace with changes in family structure. It allows spouses to insure each other's lives for unlimited amounts, but does not extend the same rights to cohabitants and other family members.
- 13.9 In Issues Paper 4, we asked whether the classes of relationship said to be based on natural affection should be enlarged.³ We tentatively proposed to provide a right for a person to insure the life of a cohabitant, and for a parent to insure the life of an adult child. We then asked if the category should be extended further, to include (for example) dependent children and siblings.
- 13.10 The 19 responses we received revealed mixed views. Several supported an extension. Heather Thomas, for example, thought the current law "positively offensive to modern readers" and an "outrage". The Association of British Insurers (ABI) and other insurers expressed support in principle, but were concerned about the details of any proposal. In particular, several respondents doubted whether it would be possible to produce a workable definition of cohabitants.
- 13.11 Other consultees, however, argued that any list of relationships would prove arbitrary. Many thought it would be better to look at whether the policyholder was in fact economically dependent on the life insured, rather than attempt to categorise family relationships.

Problems in defining cohabitants

- 13.12 The definition of a cohabitant troubled several consultees. As Geoffrey Lloyd and Derrick Cole put it:

³ Issues Paper 4, para 7.57 and following.

The situation with cohabitants is a problem of definition as has already been found in connection with giving the same legal rights as married couples to couples who are not married. It is not a matter of moral prejudice; it is how a cohabitant who has a genuine long term relationship can be distinguished from a casual boyfriend or girlfriend.

- 13.13 Aegon UK plc thought that the problem of definition would be so great that, on balance, cohabitants should not be included.

Children, parents and other relatives

- 13.14 There was some support for allowing children to insure the lives of their parents. Zurich Financial Services, for example, thought that interest should be found whether they were cared for by the parent or not.

- 13.15 Many consultees, however, expressed concern about legislating for a long list of relationships, which would apply regardless of any economic dependency. While they agreed with the general principle that the category of insurable interest supported by natural affection should be extended, the International Underwriting Association (IUA) noted:

Employing categories such as natural affection can be problematic in as much as it is difficult to assess from a social perspective how extensive the category should be and a degree of generalisation on the nature of relationships is required. It is difficult to know where to draw the line – for example, extending natural affection to include some blood relatives and not others could be contentious.

- 13.16 Some consultees were particularly concerned that grandparents or parents should have an unlimited interest in their grandchildren or children. The Reinsurance Group of America, for one, thought in such cases the amount insured should be subject to a modest monetary limit to prevent moral hazard.

Natural affection is an arbitrary test

- 13.17 Others went further and expressed concern about the whole rationale behind a test of “natural affection”. The City of London Law Society thought that the “law might do well to distance itself” from the concept “because it is difficult to define and the use of the phrase is not always appropriate on the facts”.

- 13.18 Mark Templeman QC argued:⁴

Insurable interest by way of natural affection seems an anachronistic concept in the twenty-first century. Insurance is a financial instrument. It seems odd, and counter-intuitive, to allow unlimited insurance based on an interest that is not economic (natural affection), but only to allow insurance up to the limit of the value of the interest where the interest derives from economic considerations.

⁴ M Templeman QC, “Insurable Interest: A suitable case for treatment” in Dr B Soyer, *Reforming Marine & Commercial Insurance Law* (2008) at p 224.

He thought that “there should be no expansion of the category of insurable interest by natural affection: instead, the principles of pecuniary interest should be expanded”.

- 13.19 Nicholas Legh-Jones QC agreed that it might be better to focus on a test of economic dependency:

Once an insured can insure the life of someone on whom he/she is in some way economically dependent regardless of any legal obligation to assist or maintain the insured, is there a real need to broaden your categories of natural affection?

- 13.20 Martin Mankabady of Lawrence Graham LLP illustrated the point with an example of a neighbour who provides care for another neighbour. He said were the carer to die, then the neighbour being cared for would suffer a financial consequence. It would be arbitrary to permit relatives to insure each others’ lives but not those who depended on each other in other ways.

- 13.21 The ABI was also sympathetic to the idea that the test should be based on dependency rather than family relationships. They suggested that:

The broad concept of “natural affection” might suffice rather than attempting to define a non-exhaustive list of specific relationships that might satisfy this criteria. It is worth considering supplementing this with a requirement that there should be a financial relationship between the two parties.

- 13.22 The Institute of Insurance Brokers agreed. It supported the principle of enlarging the natural affection class but thought there was a case, “based on moral hazard”, for restricting availability of cover to cases where the policyholder has a reasonable expectation of economic loss.

No presumption of coverage

- 13.23 Lloyd’s Market Association (LMA) did not see a problem with expanding insurable interest to new groups “but would not want to compromise the underwriter’s ability to turn down, or limit cover, where he cannot see an adequate financial interest on the part of the policyholder in the life of the person proposed”. They commented that:

It should be understood that whilst the legal framework should not impose limits on cover, it should equally not create an expectation – far less attempt to impose a requirement – that cover will be available.

- 13.24 We agree. Just because someone can bring themselves within a defined class, does not mean that they are entitled to be insured. This will remain an issue for the insurer’s discretion.

Conclusion

- 13.25 Most consultees wished to see the law reformed to give access to life insurance products to a wider range of people. The balance of opinion, however, favoured a test based on economic dependency rather than family relationships.

- 13.26 Providing a list of relationships where interest is presumed has the benefit of certainty but risks being arbitrary and overly prescriptive. As the IUA put it, “it is difficult to know where to draw the line”.
- 13.27 We agree with the views expressed by Nicholas Legh-Jones and by Martin Mankabady: the need to enlarge the class where insurable interest is presumed is reduced if a wider test for an insurable interest based on economic benefit is introduced.
- 13.28 Below we argue in favour of a wider test of economic dependency. With this change, we suggest only two limited extensions to the existing category of natural affection.
- (1) We ask whether parents should be allowed to insure the lives of children under 18 for a small amount. These products already exist, and we think that they should be regularised.
 - (2) Most respondents thought that cohabitants should be included, provided a suitable definition can be found.

These issues are explored below, when we set out proposals for reform.

Relationships of economic dependence

- 13.29 In theory, the law allows a person to insure another’s life if they will suffer a financial loss on the other’s death. As we describe in Part 11, however, this is an extremely limited category. The law requires “a pecuniary loss recognised by law” – that is a legally enforceable right to payment, rather than a reasonable expectation of payment. Furthermore, the amount of the insurance is limited to the amount of the legal right at the time the contract is made. This can lead to many technical distinctions. For example, insurance on key employees is limited to loss during the notice period, plus the costs of replacement. Furthermore, joint debtors may insure the principal of a loan, but not future interest payments.
- 13.30 In Issues Paper 4, we proposed that the current test should be relaxed, to cover those with a reasonable expectation of economic loss on the death of the life insured.⁵ This received widespread support. Out of 15 responses, 14 supported relaxing the test.⁶

Potential markets

- 13.31 The IUA welcomed the relaxation as it would bring certainty to areas of interest recovery and key employee coverage. Others saw that it had the potential to apply in other circumstances. Aegon UK plc thought that the extension should apply to cases where two people have a joint financial obligation or joint responsibility for the maintenance of children.
- 13.32 As the UK comes to terms with the needs of an ageing population, there is also the potential for new products to cover the life of those providing voluntary care, or the lives of those paying the care costs of parents or other relatives.

⁵ Issues Paper 4, para 7.67 and following.

⁶ One consultee did not give a definitive answer.

Concerns

- 13.33 Some respondents expressed concern about how the “reasonable expectation” of the parties should be interpreted. We do not see it as an open ended test. The expectation of loss would need to be reasonable and probable, rather than merely tenuous. In that respect it would be similar to the proposed statutory test for interest in indemnity insurance.⁷
- 13.34 The IUA observed that it would need to be “predicated by evidence provided by the insured of their potential for loss”. The LMA made a similar point; “a reasonable expectation which is not supported by evidence of potential loss is likely to be insufficient for an underwriter”. This is clearly right. As discussed below, we do not intend to impose a statutory requirement to check the insured’s circumstances, but good underwriting practice would require insurers to seek details of the interest.
- 13.35 The most significant evidence of a reasonable expectation of loss would be the relationship between proposer and the life insured itself. The test would more readily be satisfied by a cohabitant in a stable, long standing relationship where there existed clear financial dependency between the parties.

Valuing the dependency

- 13.36 Where life insurance is based on “natural affection”, it may be for an unlimited amount. Consultees thought that this was correct: all 13 people who expressed a view agreed that this rule should continue.
- 13.37 Where the interest is based on financial loss, the situation is more difficult. It is the nature of contingency insurance that it pays a fixed amount on the occurrence of a given event. If the amount of the payment is to be valued, it must be valued at the time the contract is made. Yet at this point the amount of any financial loss is inherently uncertain: the key employee may prove to be pivotal to the success of the whole organisation, or may turn out to be a liability rather than an asset. An elderly parent may continue to receive care from his or her child for the next 20 years, or the child may abandon the parent.
- 13.38 In Issues Paper 4, we tentatively proposed that where a policyholder takes out insurance on the life of another on the basis of economic loss, the value of the policy should be equivalent to the reasonable expectation of loss. This we said, would prevent an employer from insuring the life of the office tea-man for £3 million, but would allow it to insure a key board member for that amount.
- 13.39 This received a mixed response. Several consultees argued that an employer should have an unlimited interest in the lives of its employees. Aegon UK plc commented that “the insurer will impose any necessary limits on the cover that it is prepared to provide”. The LMA told us that:

The law should not impose arbitrary limits on cover; value of policies should be freely agreed between the parties to the contract on the understanding that the underwriter will normally seek justification for the amount sought, particularly for higher value cases.

⁷ See para 12.66(2).

13.40 This is a difficult issue, to which we return below.

Group life insurance

13.41 In Issues Paper 4, we explained that group insurance schemes were a common form of long-term insurance. They took several forms. Some were written through a discretionary trust, but this was not always the case. Often payments were made to employers for the benefit of employees.

13.42 It is not always clear where the insurable interest lies in group schemes. The case of *Feasey*,⁸ described in Part 11, suggests that where insurance was written on many lives over a long period, the rules on insurable interest are less strict. Uncertainty remains, however, especially where employer sponsored schemes are written for the benefit of family members. In Issues Paper 4, we asked whether special rules are necessary or would be advantageous for the group life industry.⁹

13.43 The majority of consultees thought that special rules for group policies were unnecessary. They felt that in practice insurable interest in group schemes was not a problem. The flexibility of group schemes was seen as an advantage, and there were worries about prescriptive rules which tied down the nature of the insurable interest too narrowly.

13.44 In one respect, however, consultees thought that the position could be improved. The ABI said that the law would be clearer if trustees of pension schemes were included within the category of those with an unlimited insurable interest.

13.45 Standard Life made a similar point. They identified difficulties with the insurable interest of trustees of pension and other group schemes. Where employee benefits are effected through a trust, their preferred legal analysis was that:

The employees are insuring their own lives through the trust by their own contributions or by contributions paid on their behalf by their employer in return for services to that employer.¹⁰

13.46 They noted, however, that there is no explicit judicial authority underpinning this analysis. They suggested that:

The Commissions should seek to resolve the lacuna of authority for existing practices by either removing the requirement that trustees of pension schemes need insurable interest or by providing statutory authority that these trustees have an unlimited insurable interest in the lives of the members of their schemes.

⁸ *Feasey v Sun Life Assurance Co* [2003] EWCA Civ 885; [2003] 2 All ER (Comm) 587.

⁹ Issues Paper 4 at para 7.84.

¹⁰ An alternative view might be that there is not a requirement that the trustee has an insurable interest via the employer settlor in the beneficiary's life, but there is a requirement that the beneficiary has an insurable interest in the life insured, a type of property which is then held on trust by the trustee.

13.47 We see the force of the argument. Trusts and trustees are subject to numerous equitable, statutory and common law controls which remove the risk of moral hazard. Below we propose to address the uncertainty in the current law by giving trustees in pension and group life schemes an unlimited interest in the lives of group members.

13.48 We also ask whether in employer-sponsored group schemes offering employee benefits, an employer should also have an unlimited interest in the life insured.

The consequence of lack of insurable interest

13.49 In English law, life insurance made without interest is not only void but also illegal.¹¹ This means that not only are claims not paid, but premiums may not be repayable.¹² The Scots law of unjustified enrichment may however permit recovery of premiums paid under an illegal contract that involves no “moral turpitude”.¹³

13.50 In Issues Paper 4, we proposed that life insurance written without insurable interest should be void, but not illegal. The proposal received 15 responses, unanimous in their support. Below we make a proposal to this effect.

13.51 Issues Paper 4 also considered composite policies,¹⁴ which combine elements of contingency and indemnity insurance. An example of this would be travel insurance, covering both luggage and injury. Under the current law, if the life or personal accident element is found to be illegal for lack of insurable interest, the whole policy falls. We tentatively propose that composite policies should be separable. If there is insufficient interest for the life policy, only that part of the policy should fall.

13.52 We received 13 responses, of which 11 supported the proposal. Several commented that it was already industry practice. As the ABI said:

Policies are often written in this way and this proposal would not be a great change to the way the industry operates.

13.53 Some insurers which supported the proposal were concerned about how to divide up a single premium so that the life element could be repaid. The IUA commented that this would have to be approached on a case by case basis, depending on “how the risk was initially rated, placed and packaged”.

¹¹ *Harse v Pearl Life Assurance Co Ltd* [1904] 1 KB 558.

¹² Note that in his 1989 Insurance Ombudsman Bureau Annual Report the ombudsman said he would not treat these policies as illegal.

¹³ *Cuthbertson v Lowes* (1870) 8 M 1073; cf *Jamieson v Watt's Trs* 1950 SC 265.

¹⁴ By which we mean a single policy that covers a number of different risks rather than one which covers the interests of a number of different persons in the same insured subject matter. See Issues Paper 4, para 4.16 and following and para 7.91 and following.

- 13.54 Similar issues are raised elsewhere in insurance law. For example, in *Swiss Reinsurance Company v United India Insurance Company Ltd*,¹⁵ the policyholder paid a single premium, and then sought repayment of a portion for a period during which the policy had lapsed. That claim failed because the single premium was payable for the entire risk. We envisage that similar principles would apply. Where it is impossible to separate out elements of the premium, then no part of the premium is repayable. Where it is possible to sever the policy and to identify the individual cost of the voided portion, then it should be returned to the policyholder.

The names of interested parties

- 13.55 Section 2 of the Life Assurance Act 1774 requires that the name of the person who benefits must be inserted into the policy. If not, the policy may be avoided. The section only needs to be satisfied at the outset. It does not prevent the immediate assignment¹⁶ of the policy to someone entirely unconnected to the life insured.¹⁷
- 13.56 In Issues Paper 4, we proposed the repeal of section 2. We received 12 responses, of which most agreed with us. The ABI had “no problem” with the proposal. By contrast, the IUA disagreed. They commented that:

To lose this requirement would send out a poor policy message in terms of efficient risk assessment, administration and contract clarity and may cause unnecessary complications at the claims handling stage.

- 13.57 In Part 15 we explore the issue of whether insurance contracts should meet any formal requirement. We explain that it is clearly good practice for insurance contracts to be set out in writing, and include all the terms of the contract, including the names of the parties. It does not follow, however, that such formalities should be required by statute. If they are to be required, the sanction must be appropriate. In this case, the sanction is clearly inappropriate: the insurer’s failure to insert the name allows the insurer to refuse the claim. Even the IUA accepted that the sanction would never be applied in practice.
- 13.58 We think the form of insurance contracts should be left to the industry, if necessary backed by regulation. Below we propose that section 2 of the Life Assurance Act 1774 should be repealed.

Other issues

- 13.59 We made three other proposals, which consultees did not support and which we are no longer pursuing. We mention them only briefly.

¹⁵ [2005] EWHC 237; [2005] 2 All ER (Comm) 367.

¹⁶ Or, in Scots law, assignation.

¹⁷ See Issues Paper 4 at paras 4.9 and 4.10; paras 6.9 and 6.10 and para 7.98 and following.

Consent of the life insured

- 13.60 In Issues Paper 4, we considered whether there should be an alternative means of establishing insurable interest based on the consent of the life insured.¹⁸ The suggestion was overwhelmingly rejected. Many consultees worried that consent might be obtained by duress or other objectionable behaviour, particularly where the life insured was elderly or very young. Others questioned what might happen where consent was subsequently withdrawn. If the test for pecuniary interest is relaxed, there is no longer a need for this category.

Insurers' duty to inquire

- 13.61 In the Issues Paper we asked whether an insurer should be under a statutory duty to check that the policyholder had a sufficient insurable interest in the life assured.¹⁹
- 13.62 Of the 13 responses received, 9 did not support this proposal. Most said that the insurer would check as a matter of course, but it was unnecessary to impose a statutory duty. It might contribute to additional costs or duplicate other regulatory requirements, including the principle of Treating Customers Fairly.²⁰ We do not pursue the issue further.

Assignment or assignation of policy

- 13.63 The requirement for insurable interest in life insurance must be satisfied at the outset of the contract and not at the point of loss.²¹ In Issues Paper 4, we pointed out that once a contract of life insurance is made, the benefit may be immediately assigned to a stranger without interest.²² Nor does a life policy taken out on the life of a spouse automatically terminate on divorce or separation.²³ This may lead to moral hazard. We asked whether there was any need to reform this area of law.
- 13.64 We received 10 responses, which were unanimous in rejecting the need for any reform. It was thought that reform would cause practical problems in the Traded Endowment Policies market, and destabilise insurance products as investment vehicles. Furthermore, it was argued that there was no evidence of social ills resulting from the assignment of life policies. As the ABI put it:

¹⁸ Issues Paper 4, para 7.71 and following.

¹⁹ Issues Paper 4 at para 7.88.

²⁰ The Treating Customers Fairly principle, regulated by the Financial Services Authority, requires that insurers must pay due regard to the interests of the customer and treat them fairly.

²¹ *Dalby v India and London Life Assurance Company* (1854) 15 CB 365. See also *Turnbull & Co v Scottish Provident Institution* (1896) 34 SLR 146 (OH).

²² This does not contravene the Life Assurance Act 1774, s 2 nor is the policy invalidated by the assignment; *Ashley v Ashley* (1829) 3 Sim 149.

²³ Where the policy is written in trust and names the spouse as beneficiary the spouse acquires an immediate vested interest; see *Cousins v Sun Life Assurance Society* [1933] Ch 126. In other circumstances it might be possible to cancel the policy under a policy term.

The ABI believes that reform is not needed in this area. Most predominantly it would not be advantageous to the Traded Endowment Policies ('TEPS') market, which works well for customers under current regulation as it offers a better price to the policyholders than surrendering the policy.

13.65 We do not make any further proposals on this issue.

PROPOSALS FOR REFORM

13.66 We propose to restate the law of insurable interest for contingency insurance, with some limited extensions. The main extension would be to widen the category of those able to insure the life of another on the basis of financial loss. At present, the law requires "a pecuniary interest recognised by law". There was widespread support for widening the test to one based on a reasonable expectation of economic loss.

13.67 The new test of economic dependency means that there is less need to widen the categories of "natural affection", that is, those entitled to insure another person's life without evidence of loss. We ask about three possible extensions: to children under 18 (for small amounts); to cohabitants; and to the trustees of pension and other group schemes.

13.68 In practice, policies are frequently written on the basis of an insurable interest which does not fall within the narrow tests set out in the traditional case law. If the matter were to come before the court, the courts would strive to find an insurable interest, and may well expand the categories to fall into line with commercial practice. We are nevertheless concerned about the mismatch between law and practice in this area. It leads to uncertainty, and may bring the law into disrepute if it is seen to be flouted. It is also possible that unduly restrictive law prevents some people from obtaining life insurance even though they have a valid reason for seeking it.

Proposal 1: Insurable interest based on economic loss

13.69 At present, a proposer may only insure the life of another on the basis of economic loss if a pecuniary interest "recognised by law" can be demonstrated. This requires the proposer to show that the benefit is based on a legal obligation, rather than a moral or factual arrangement. The cases interpret this strictly, finding (for example) that there is no obligation on a son to bury his mother, or on a mother to keep house for her son.²⁴ This makes it difficult for people to insure the lives of family members other than spouses, even if they are economically dependent on them, and would suffer a loss if they died.

²⁴ *Harse v Pearl Life Assurance Co Ltd* [1904] 1 KB 558.

- 13.70 The problem is compounded by the requirement in section 3 of the Life Assurance Act 1774 that “no greater sum shall be recovered” than “the amount of the value of the interest”. This imposes a limit on the insurance cover of key employees to the loss during the notice period. It also means that joint debtors can insure for the amount of the loan at the time of the contract, but cannot make provision for future possible interest. We are told that these rules are often ignored in practice.
- 13.71 It is time to bring the law into line with modern practice. We propose that an insurable interest may be found where the proposer has a real probability of economic loss on the death of the person insured.²⁵
- 13.72 The more difficult issue is whether the insured amount should be confined to a reasonable expectation of the likely benefit or loss. Such valuations are inevitably uncertain and subjective: no-one can know exactly how valuable an employee will be to a firm at the time of death. Several consultees urged us to leave the matter entirely to the insurer’s discretion. On the other hand, the principle of insurable interest suggests that there should be some link: as we said in the Issues Paper,²⁶ insuring the life of the tea-man for £3 million seems to be more like gambling than insurance.
- 13.73 It would be possible to maintain a very loose, general test that the amount of the insurance must be reasonable, given the likely loss that the proposer will suffer. This would be assessed at the time of the contract and would need to allow the parties some element of discretion in reaching inherently subjective valuations. We welcome views on this issue.
- 13.74 **Do consultees agree that an insurable interest may be found where there is a real probability that the proposer will retain an economic benefit on the preservation of the life insured or incur an economic loss on the death?**
- 13.75 **Should the law require that the value of the policy is a reasonable valuation, made at the time of the contract, of the possible loss?**

Proposal 2: Insurance without evidence of economic loss

- 13.76 Under the current law, a person may insure their own life, and that of a spouse or civil partner without evidence of financial loss. These categories are said to be based on “natural affection”. We do not propose a major extension of these categories. We would, however, welcome views on three more limited extensions.

²⁵ In the case of children who may want to insure the life of a parent on whom they are dependent for maintenance this would bring the law in England & Wales into line with current Scots law whereby a child may have an insurable interest in the life of a parent to the extent of the obligation of aliment; see further paras 11.75 and 11.76 above.

²⁶ Issues Paper 4, at para 7.68.

Children under 18 (for a small amount)

- 13.77 Several insurance products, such as family travel insurance, provide small payments to parents on the death or injury of a child under 18.²⁷ Although parents are very rarely economically dependent on children under 18, there is clearly a demand for such products. We think that it is unsatisfactory that the law should be out-of-line with market practice in this way.
- 13.78 There is already a small exception permitting parents to insure the lives of their children for limited amounts. A parent may rely on section 99 of the Friendly Societies Act 1992 to insure a child's life with a friendly society. If the child is under the age of 10, the amount recoverable is limited to £800. We think this is too limited, first because it applies only to friendly societies, and secondly because £800 is an unduly low figure.
- 13.79 We therefore propose to expand the current law, to allow parents to insure the life of a child under 18 with any insurer, not just friendly societies. The right would extend to the legal parents of a child and all those who treat a child as a child of the family.
- 13.80 Consultees expressed concern about the risk of moral hazard and argued that the insured sum should be capped at a modest amount. In England and Wales, under the Fatal Accidents Act 1976, bereavement damages are capped at £11,800 plus reasonable funeral expenses. A funeral may well cost up to £3,000, suggesting an overall figure of around £15,000. In Scotland, however, while the courts have in effect laid down guidelines on the range of damages which should be paid for non-patrimonial loss arising from such a death, the courts can depart from them in exceptional circumstances. It appears that, at present, an award of £30,000 for each parent might provide a ceiling.²⁸
- 13.81 The amount of bereavement damages in England and Wales has been criticised as being too low. Several consultees suggested that £30,000 (that is, something akin to the Scottish figure) might be a more realistic figure.
- 13.82 We ask whether there should be a cap on the amount for which children's lives may be insured and, if so, would welcome views on an appropriate amount. We also welcome views on how the amount should be set. Clearly, it would need to be increased by regulation, but there is always a danger that the amount may not be updated sufficiently regularly. One possibility would be to peg it at (say) twice the level of bereavement damages (at £23,600), so that as bereavement damages increased, the permitted amount also increased. But this would apply in a different way in Scotland.

²⁷ A cursory trawl through the internet gives some indication of the availability of these insurance products, many of which are offered as add on products to bank account customers.

²⁸ The Damages (Scotland) Act 2011 regulates awards of damages in, *inter alia*, cases of wrongful death. See also the Scottish Law Commission's Discussion Paper on *Damages for Wrongful Death* (2007), Discussion Paper No 135, paras 3.5, 3.22 and 3.62, which sets out examples of awards of damages of up to £30,000 per parent for non-patrimonial loss in such circumstances.

13.83 The limit would be per policy. We do not think that there is any realistic way of controlling people from taking out multiple policies on the same child. Indeed, parents may do so without any form of wrongdoing: a parent may be provided with cover under a work-related scheme, as an “add-on” to a bank account and again under a travel policy. If asked directly about other insurances that may provide cover for a child a parent may, in all honesty, not mention the first two simply because they are unaware that they do this. On the other hand, where a child died in suspicious circumstances, the fact that the parents had large numbers of life policies may lead to questions being asked.

13.84 **Do consultees agree:**

(1) **that parents should be entitled to take out insurance on the life of a child under 18?**

(2) **that the right would extend to the legal parents of a child and all those who treated a child as a child of the family?**

13.85 **Do consultees consider that there should be a cap on the amount for which children’s lives may be insured?**

13.86 **If the amount is capped we welcome views on what the amount should be and on how it should be set.**

Cohabitants

13.87 The next limited extension concerns cohabitants, by which we mean couples who live together in an intimate relationship but who are not married or in a civil partnership.

13.88 Cohabitation has become increasingly common and all the indications are that this trend will continue. Recent population studies have revealed that in 2007 the number of cohabiting couples in England and Wales was 2.25 million and this is projected to rise to 3.7 million in 2031.²⁹ Similarly, cohabitation has become increasingly popular in Scotland, with the percentage of adults in Scotland who cohabit rising from 5% in 1999/2000³⁰ to 10% in 2007/08.³¹ By 2008, it was estimated that the number of cohabiting adults in Scotland was 372,000.³²

²⁹ Office for National Statistics, *Number of cohabiting couples projected to rise in England & Wales*, News Release (31 March 2009). The results for cohabitation cover only opposite sex cohabitation, stated to be due to the difficulties in estimating same-sex cohabitation for reliable results on the current methodology (see Background Note 6 to the News Release). See also B Wilson, “Estimating the cohabiting population” (2009) 136 *Population Trends* at pp 21, 23.

³⁰ *Scotland's People: Annual Report: Results from the 1999/2000 Scottish Household Survey* (2001), p12.

³¹ *Scotland's People: Annual Report: Results from the 2007/2008 Scottish Household Survey* (2009), p12.

³² Centre for Research on Families and Relationships, *Legal Practitioners' Perspectives on the Cohabitation Provisions of the Family Law (Scotland) Act 2006* (2010), p8.

- 13.89 Many consultees expressed support for including cohabitants within the category of those with a presumed interest in another's life, provided that a clear, workable definition could be found. One of the major practical concerns about providing for such an exception to the need to demonstrate an insurable interest is the problem of devising a suitable test to identify entitled cohabitants. The issue is not a question of moral or social prejudice – it comes down to being able to differentiate between the diverse kinds of relationship that people form. We have therefore considered what the definition might be.
- 13.90 Many cohabitations are all but identical to marriage or civil partnership, but many are not. The case of *Ghaidan v Godin-Mendoza*³³ concerned the succession rights of the survivor of a cohabiting couple to a Rent Act tenancy.³⁴ In that case, a relationship of cohabitation was described as being one where the parties had “the sense of belonging to one another which is the essence of being a couple” and of having “the stability and permanence which go with sharing a home and a life together, with or without ...children”. We think that what is required is a definition which captures the idea of a couple living together in a stable, long-term relationship.
- 13.91 The existing statutory definitions of cohabitation focus on relationships with qualities that are associated with marriage or civil partnership, and refer to a couple who have lived in the same household as spouses,³⁵ or as if they were spouses. Most also require that this has been the case for a prescribed period of a minimum duration. The duration requirement can vary, which has potential drawbacks. There is a risk of inconsistency between the different statutory schemes and, wherever the length of the minimum duration requirement is set, it may appear arbitrary, leaving those excluded with a sense of injustice.

³³ [2004] UKHL 30, [2004] 2 AC 557.

³⁴ Rent Act 1977, sch 1.

³⁵ For example the Inheritance (Provisions for Family Dependents) Act 1975; the Fatal Accidents Act 1976; the Family Law Act 1996; and the Family Law (Scotland) Act 2006 which does not require a minimum period of cohabitation.

- 13.92 In Scots law, however, there are no minimum periods of cohabitation in the reforms introduced by the Family Law (Scotland) Act 2006 in connection with financial provision upon death of one of the cohabitants or the break-up of the cohabitation relationship.³⁶ Section 25 of the Act provides that a person is a cohabitant if either a member of a couple consisting of (a) a man and woman who are or were living together as if they were husband and wife; or (b) two persons of the same sex who are or were living together as if they were civil partners.³⁷ When determining whether or not a couple are cohabitants, the court is to have regard to the length of the period during which the parties have been living together, the nature of their relationship during that period and the nature and extent of any financial arrangements which subsisted during that period.³⁸
- 13.93 In its Report on Succession,³⁹ the Scottish Law Commission has made further recommendations in relation to cohabitants providing for a new statutory regime (applying to testate as well as intestate estates) providing succession rights for cohabitants. It is similar to the requirements of the 2006 Act in that there is a list of factors to be taken into account when determining whether or not a couple were cohabitants for the purposes of the rules of succession. There is no minimum duration requirement.
- 13.94 Having no minimum period of cohabitation in Scotland has resulted in some couples being classed as cohabitants under section 25 of the 2006 Act after cohabitation periods of less than three years. For example, in the case of *Savage v Purches*,⁴⁰ the pursuer and the deceased were held to have been cohabitants within the meaning of section 25 following a period of approximately 2 years and 8 months. In making financial provisions following separation from or death of a cohabitant, however, Scottish courts can have regard to the length of the period during which the parties lived together. Indeed, in the case of *Savage v Purches*, the relatively short duration of the cohabitation was one of the factors cited as justification for the pursuer being made an award of nil. Despite this, when making financial provisions in cohabitation cases, the Scottish legislation requires the courts to focus on the economic dependence of the parties rather than the duration of the relationship.⁴¹

³⁶ The Act has its origins in recommendations made by the Scottish Law Commission in their Report, *Family Law*, (1992) Scot Law Com No 135.

³⁷ Section 25 (1).

³⁸ Section 25 (2). Furthermore, in their 1992 Report on *Family Law* (1992), Scot Law Com No 135, the Scottish Law Commission recommended (at 16.41) that a cohabitant should have an insurable interest in the life of the other cohabitant with no qualifying period of cohabitation. This recommendation has not been implemented.

³⁹ (2009) Scot Law Com No 215 (not implemented as at the date of publication).

⁴⁰ 2009 SLT (Sh Ct) 36.

⁴¹ S 25(2) Family Law (Scotland) Act 2006. See, for example, *Gow v Grant* [2011] CSIH 25, 2011 SC 616, 2011 Fam L R 50 and *Mitchell v Gibbon* 2011 Fam L R 53.

- 13.95 We have decided not to adopt this approach for the purposes of the proposed reform. Under our proposed scheme, the majority of cohabitants would be entitled to insure each other's lives on the basis of a real probability of economic loss. This would apply where the cohabitants entered into a joint mortgage, or where they shared responsibility for a child. This means that in practical terms a couple who are in a relationship of economic dependence, such as that which the Scottish courts have focused on, would have an insurable interest in each other's lives long before the threshold had been reached. They would just have to demonstrate it.
- 13.96 The cohabitation test is simply an alternative way of showing insurable interest, to simplify the underwriting process for long-term cohabitants. A minimum duration requirement provides a clear-cut bench mark for whoever must make the decision, in this case an insurer.
- 13.97 Two issues remain to be decided: what are the qualities of an eligible relationship and what should the minimum duration period be. We think that the first of these is straightforward.
- 13.98 In England and Wales, several statutes make provisions for cohabitants. The most significant for our purposes are the Inheritance (Provision for Family and Dependents) Act 1975 (the 1975 Act)⁴² and the Fatal Accidents Act 1976 (the 1976 Act).⁴³ They both provide for orders for financial provision to be made in favour of cohabitants on the death of one of the partners. The Acts give an entitlement to apply for an order to those who were, for a continuous period of two years ending immediately before the death living in the same household as the deceased as the spouse of the deceased. This is similar to the Scottish requirement that the parties be living together as husband and wife or as civil partners.⁴⁴
- 13.99 Basing our proposed definition on these Acts has the benefit that there is a body of case law that considers questions about involuntary absence from the shared household immediately before the death during the qualifying period; this will provide valuable precedent. Moreover, if an established definition is used which requires the couple to be living together as spouses there is no need to exclude expressly from the statutory definition those who are too young to marry or enter into a civil partnership or those who are within the prohibited degrees for marriage or civil partnership.

⁴² Section 1(1A).

⁴³ Section 1(3)(b).

⁴⁴ See above, para 13.92.

13.100 Next we turn to the minimum duration requirement. For present purposes, we favour a reasonably long period and suggest 5 years. This is longer than the prescribed periods in the 1975 and 1976 Acts.⁴⁵ Under these Acts an eligible cohabitant acquires no more than an entitlement to apply for financial provision from the estate of the deceased. The same is true of the Scottish legislation. Whether that application succeeds, and to what extent, is entirely at the discretion of the court. As we have explained, under our scheme, most cohabitants would be able to insure each other on the basis of economic dependency where they can show this. This is an additional proposal, to provide long-term cohabitants with a simpler alternative way to insure each other's lives, without having to provide evidence of dependency.⁴⁶ Given that this definition applies in the absence of evidence of dependency, we think that a longer period is justified.

13.101 The proposal we make includes a requirement for a prescribed minimum period of 5 years to have elapsed during which a couple have lived together as if spouses before they have an insurable interest in their partner irrespective of whether they can show economic dependency. We welcome views on whether a shorter period would be more appropriate.

COHABITANTS WITH CHILDREN

13.102 We have considered whether cohabitants who live together in the same household as spouses where there is a child should be treated any differently to childless cohabitants. We have concluded that they should not. Again, under our proposals, most cohabitants with children would qualify on the basis of economic dependency. Furthermore, providing that an insurable interest is presumed where there is a child adds innumerable complications to what should be a relatively straightforward contractual transaction: for example, does the child have to have been born to qualify, must the child be a blood relative or simply one treated as a child of the family, and does the child have to reside for most or all of the time with the couple?

13.103 **Do consultees agree that a person should have an insurable interest in the life of another, irrespective of whether they can show economic loss, where they have lived in the same household as spouses (husband, wife or civil partner) during the whole of the period of five years ending immediately before the contract of life insurance is taken out?**

⁴⁵ This is in line with the recommendation in our report, Intestacy and Family Provision Claims on Death, Law Com No 331, for a 5 year duration requirement under the intestacy rules, which if satisfied entitles the survivor of a cohabiting relationship (where there were no children) to inherit on the intestate's death. The report was published on 14 December 2011. We think that this entitlement to inherit on death is akin to the entitlement to receive the proceeds of life insurance.

⁴⁶ As we have explained above at paras 13.23 and 13.24 there is no presumption of coverage; an insurer must agree to extend cover and the insurance is subject to the usual principles of insurance law.

Trustees of pension or group schemes

- 13.104 It is common for the trustees of pension schemes to insure the lives of their members, though the legal basis for doing so is not entirely clear. As noted earlier, consultees asked us to address this uncertainty by providing statutory authority that trustees of pension and other group schemes have an unlimited insurable interest in the lives of the members of their schemes.
- 13.105 We also ask whether in employer-sponsored group schemes offering employee benefits, an employer should also have an unlimited interest in the lives insured.
- 13.106 **Should the statute clarify that trustees of pension and other group schemes have an unlimited insurable interest in the lives of the members of the scheme?**
- 13.107 **Should an employer also have an unlimited interest in the lives of its employees when entering into a group scheme whose purpose is to provide benefits for its employees or their families?**

Proposal 3: Repealing section 2 of the Life Assurance Act 1774

- 13.108 Section 2 requires that the name of the person who benefits from life insurance must be inserted into the policy. If not, the policy may be avoided. This sanction is clearly inappropriate: the insurer's failure to insert the name allows the insurer to refuse the claim.
- 13.109 Although it is clearly good practice for insurance contracts to be in writing and include the names of the parties, we do not think that such formalities should be required by statute. Instead, the form of insurance contracts should be left to the industry, if necessary backed by regulation. We propose that section 2 of the Life Assurance Act 1774 is repealed.
- 13.110 **Do consultees agree that section 2 of the Life Assurance Act 1774 should be repealed?**

Proposal 4: A new statutory requirement for insurable interest

- 13.111 In Part 12, we proposed to clarify the law through a new statutory requirement for insurable interest in indemnity insurance. As discussed in Part 10, the distinction between indemnity insurance and contingency insurance is far from exact. As far as possible, the same rules should apply to both forms of insurance. We therefore propose that the new requirement should apply to all forms of insurance except marine insurance. It should replace the requirement set out in the Life Assurance Act 1774.
- 13.112 For both forms of insurance, if insurable interest is not present, the contract would be void (but not illegal). For composite policies, where insurable interest was present for some part of the insurance but not others, the policy should be treated as separable. In other words, if there was insufficient interest for the life element, but sufficient interest for the indemnity element, only the life element would be void.

- 13.113 The main difference between contingency and indemnity insurance would be in the timing of the insurable interest. For indemnity insurance, the interest may exist at the time of the contract or at the time of the loss. For contingency insurance, it must be present at the time of the contract.
- 13.114 In Part 12, we asked whether we should set out a non-exhaustive list of ways in which the requirement of insurable interest may be demonstrated in indemnity insurance. We ask whether we should do the same for contingency insurance, to include the list of those who may insure by reasons of “natural affection”, and those who may insure because of a real probability of economic loss. The Court of Appeal decision in *Feasey*⁴⁷ makes it clear that the categories are open-ended, and may be developed in the future. This would need to be reflected in any new statute.
- 13.115 **Do consultees agree that:**
- (1) a new statutory requirement for insurable interest should replace that set out in the Life Assurance Act 1774?**
 - (2) if insurable interest is not present, the contract would be void but not illegal?**
 - (3) for composite policies, where insurable interest was present for some part of the insurance but not others, the policy should be treated as separable?**
 - (4) for contingency insurance, insurable interest must be present at the time of the contract?**
- 13.116 **Should the statute provide a non-exhaustive list of insurable interest in contingency insurance?**

⁴⁷ *Feasey v Sun Life Assurance Co* [2003] EWCA 885, [2003] 2 All ER (Comm) 587.

CHAPTER 4

POLICIES AND PREMIUMS IN MARINE INSURANCE

PART 14

POLICIES AND PREMIUMS IN MARINE INSURANCE: INTRODUCTION

- 14.1 At the outset of our insurance project in 2006, we were asked to consider two provisions of the Marine Insurance Act 1906 which appeared outdated and problematic. These were the requirement for a formal marine policy in section 22 and the broker's liability for premiums, set out in section 53(1). Both provisions apply only to marine insurance.
- 14.2 We considered the need for a formal policy in Issues Paper 9 and the broker's liability for premiums in Issues Paper 8. It soon became clear that these provisions could not be considered in isolation. They reflect an approach to doing business which developed at Lloyd's in the eighteenth century and received judicial recognition in a series of nineteenth-century cases. These cases were then codified into statute in 1906. Market practice has changed substantially over the last hundred years, but the statute remains much as it was.¹

CHANGING MARKET PRACTICE

- 14.3 Several provisions of the 1906 Act reflect a way of doing business based on two contract documents. The broker would present the underwriter with a slip, which the insurer would sign, concluding a contract between them. The contract would not be enforceable, however, until the underwriter had issued a policy document and paid stamp duty on it.
- 14.4 This has changed. Stamp duty on marine insurance policies was abolished in 1970. Recent industry initiatives stress the advantages of one single contract document rather than two. We think that the 1906 Act should be updated to reflect this.
- 14.5 Furthermore, in 1906 marine underwriters did not look to the insured for payment. Instead, the insurer claimed the premium from the broker, and the broker had a separate claim against the insured. The insured paid the broker not as an agent, but as a principal: the broker was entitled to the premium in its own right. There is uncertainty about how far this is still the law.
- 14.6 The idea that the insured pays the broker as principal appears to be incompatible with Financial Services Authority (FSA) rules to protect client money. The Client Assets Sourcebook (CASS) rules set out in the FSA rulebook are based on the idea that the broker holds the premium as an agent, either for the insurer or the insured. We are concerned that the mismatch between the 1906 Act and the CASS rules could lead to legal risks and uncertainties if a marine broker were to become insolvent.

¹ Sections 21, 23, 25(2) were partially repealed by the Finance Act 1959 (c.58) and sections 92, 93, Sch.2 were repealed by the Statute Law Revision Act 1927(c.42). Section 22 is excluded by the Marine and Aviation Insurance (War Risks) Act 1952 (c.57), section 7(1) and Finance Act 1959 (c.58), section 30(6)(7).

UPDATING THE 1906 ACT

- 14.7 In this chapter we explain why we think the law should be updated to reflect current practice. The UK is one of the world's leading insurance law jurisdictions, yet the 1906 Act includes many provisions which are outdated, unused and uncertain. This undermines the respect with which the law is held.
- 14.8 If the 1906 Act is to be reformed, we think the opportunity should be taken to remove the need for two contract documents. We also think that section 53(1) poses risks for insurers and policyholders. We propose to clarify the section to ensure that policyholders are liable to pay the insurer as principal, and to pay the broker as agent. We ask how far brokers should be liable to pay the insurer if the policyholder becomes insolvent.
- 14.9 Many of the repeals and reforms we recommend are minor and technical. They are however, quite extensive, and affect around a dozen provisions of the 1906 Act. As it is important that none of the proposed changes have unforeseen consequences, we describe the provisions and set out our proposals in relation to each of them.

THE STRUCTURE OF THIS CHAPTER

- 14.10 This section is divided into six further parts, as follows:
- (1) In Part 15 we look at section 22 of the 1906 Act, which requires there to be a formal policy document. In Issues Paper 9 we tentatively proposed the repeal of this requirement.² Here we summarise the arguments for repealing section 22 and removing the need for a marine insurance contract to be embodied in a formal document.
 - (2) In Part 16 we examine the implications of removing the requirement for a marine policy on the rest of the 1906 Act. The 1906 Act uses the word "policy" or "policies" 166 times. On most occasions, the word "policy" simply means an enforceable contract. There are however, four provisions which use the word "policy" to refer to a document rather than a contract. These are sections 2(2), 30, 50(3) and 52. We discuss each in turn.
 - (3) In Part 17 we propose the repeal of the requirement for a formal marine policy. Although it is good practice for the parties to put the terms of the contract in writing, we think this can be left to the market rather than being required by statute. We set out proposals for repealing or amending ten provisions of the 1906 Act.

² Insurance Contract Law Issues Paper 9: The Requirements for a Formal Marine Policy (October 2010), para 5.23.

- (4) In Part 18, we consider a marine insurance broker's liability to pay premiums under section 53(1) of the 1906 Act. In Issues Paper 8,³ we described this provision as anomalous, counter-intuitive and uncertain. Section 53(1) needs to be understood in the light of its common law background, which means there may be more to this provision than first appears. We describe the implications of the section when either the policyholder or the broker becomes insolvent.
- (5) In Part 19 we set out the case for reforming section 53(1). We argue that policyholders should be liable to pay premiums to the insurer, and should pay brokers as agents. Insurers may wish to seek added protection from the broker, and brokers should be free to agree to be jointly and severally liable to the insurer for the premium. We provisionally propose default rules to reflect current market practice: namely that marine brokers would assume joint and several liability for premiums, while non-marine brokers would not. Brokers and insurers would be able to change these default rules through a simple contract term.
- (6) Finally, in Part 20, we consider the marine insurance broker's lien over the policy document and proceeds under section 53(2). We identify the problems with this section, and propose that section 53(2) should be repealed and replaced by a new provision which applies to both marine and non-marine business. We also look briefly at receipts of premium under section 54, and propose the repeal of this section.

³ Insurance Contract Law Issues Paper 8: The Broker's Liability for Premiums: Should Section 53 be Reformed? (July 2010), para 6.2(1).

PART 15

THE NEED FOR A MARINE POLICY: SECTION 22 OF THE MARINE INSURANCE ACT 1906

- 15.1 Under section 22 of the Marine Insurance Act 1906, a contract for marine insurance is inadmissible in evidence unless “embodied in a marine policy”. This introduces a technicality with potentially drastic consequences for the insured. It means that without a marine policy, the insured cannot prove the existence of a contract, and therefore cannot establish its right to make a claim.
- 15.2 This requirement for a policy originated as a way of preventing tax evasion, as in 1795 stamp duty was imposed on marine insurance. The tax did not apply to the contract as such, but to the document, which had to be stamped. To make sure that the parties paid the duty, a succession of statutes declared insurance contracts to be invalid without a formal stamped policy. Section 22 is the successor to these provisions.
- 15.3 Stamp duty on marine policies was abolished in 1970. This removed the need for section 22. Yet the section remains, as an anomalous and potentially troublesome provision. It only applies to marine insurance. In other forms of insurance there is no requirement for the contract to be in any particular form.
- 15.4 In Issues Paper 9, we commented that the section appeared to have little effect in practice. We are not aware of any recent cases in which an insurer has refused to pay a claim because the insured could not produce a policy. If the point were taken however, the law is far from clear. Given that the rationale for section 22 has disappeared, we think that it is difficult to defend its continued existence.
- 15.5 In this Part, we describe section 22. We look at the role it played within the scheme of the 1906 Act, and how it would be interpreted today. We then summarise the case for reform. In Part 16, we consider the effect of repealing section 22 on other sections of the Act.

SLIPS AND POLICIES: THE SCHEME OF THE 1906 ACT

- 15.6 Section 22 reads as follows:

Contract must be embodied in policy

Subject to the provisions of any statute, a contract of marine insurance is inadmissible in evidence unless it is embodied in a marine policy in accordance with this Act. The policy may be executed and issued either at the time when the contract is concluded, or afterwards.

15.7 In the nineteenth century, the normal practice at Lloyd's was for the broker to present the underwriter with a "slip". This was a written note of the main terms of the agreement. The underwriter would sign the slip, concluding a contract between the insurer and the insured. A formal policy would then be prepared and stamped, and sent to the broker. The broker had a lien over the policy: the broker would only release the policy to the insured once the premium had been paid. The policy was important because without it the insured would find it difficult to establish a claim. The courts would not uphold a slip without a policy as this would be to condone evasion of stamp duty.

15.8 The relationship between a slip and a policy was considered in *Ionides v Pacific Fire & Marine Insurance Co.*¹ Mr Justice Blackburn explained that:

The slip is clearly a contract for marine insurance, and is equally clearly not a policy.

15.9 A contract based on a slip could not be enforced in the absence of a policy. Once a policy had been issued, however, the slip could be used as evidence of the parties' intentions. This was upheld on appeal. The 1906 Act gives statutory form to the decision in *Ionides*, which in turn upholds the Lloyd's practice of the time. It makes an important conceptual distinction between a contract and a policy.

15.10 Section 21 states that the contract is concluded when the insured's proposal is accepted, even if the policy is issued later:

A contract of marine insurance is deemed to be concluded when the proposal of the assured is accepted by the insurer, whether the policy be then issued or not; and, for the purpose of showing when the proposal was accepted, reference may be made to the slip or covering note or other customary memorandum of the contract.

15.11 Section 89 confirms that only when the policy is provided, may the court also consider the slip:

Where there is a duly stamped policy, reference may be made, as heretofore, to the slip or covering note, in any legal proceeding.

The 1906 Act is therefore built around a custom which used two documents: a slip to conclude the contract and a policy which must be stamped.

15.12 Initially, the courts strictly upheld the requirement that the insured must have a policy. In *Fisher v Liverpool Marine Insurance Co* for example,² the insurer had signed the slip but had not executed a policy before the insured suffered loss. The insured admitted that the slip could not be used as evidence of the insurance contract, but argued that the slip could be used to prove the existence of a separate, collateral contract to prepare and execute the policy. The court rejected this argument, on the grounds that:

¹ (1871) LR 6 QB 674.

² (1874) LR 9 QB 418.

The whole transaction is one, an entire and indivisible contract; and in my opinion, that one entire and indivisible contract cannot be enforced.³

- 15.13 Although *Fisher* preceded the 1906 Act, it has been upheld in later cases. For example, in the Scottish case of *Liquidator of Clyde Marine Insurance Co Ltd v Renwick & Co*,⁴ Lord President Clyde observed that section 22 prevented an oral contract for the execution of a policy from being enforceable.⁵
- 15.14 The only glimmer of hope for the insured was provided in *Swan and Cleland's Graving Dock and Slipway Co v Maritime Insurance Co and Croshaw*.⁶ The claimant could not produce a policy, because it had been handed over to the insured's mortgagee. The court found that the insured did not have to produce the policy itself, provided the insured could prove that a policy had been issued.⁷
- 15.15 Despite the problems faced by the insured, the requirement for a formal paper document had practical uses. It provided helpful security for the broker, who was given a lien over the policy under section 53(2). It also provided an effective way of assigning rights under an insurance contract, particularly for cargo insurance. Sellers could assign the benefit of insurance on goods to buyers by indorsing the policy and handing it over. Thus section 50(3) states that:

A marine policy may be assigned by indorsement thereon or in other customary manner.

THE MOVE TO A SINGLE CONTRACT

- 15.16 With the abolition of stamp duty on marine policies in 1970, insurers no longer needed to prepare formal policies. Nevertheless, the culture of "deal now, detail later" remained. In 2004, the Financial Services Authority (FSA) challenged the insurance industry to end this culture, especially as details were sometimes not provided at all.
- 15.17 This led to two initiatives. The first was the Contract Certainty Code of Practice, which encouraged the parties to produce a document containing all the terms at the time the contract was agreed.⁸

³ *Fisher v Liverpool Marine Insurance Co* (1874) LR 9 QB 418, at p 425.

⁴ 1924 SC 113.

⁵ Above, at p 123. See also *Genforsikrings Aktieselskabet (Skandinavia Reinsurance Co of Copenhagen) v Da Costa* [1911] 1 KB 137, which refused to enforce a contract where a policy had not been provided, contrary to the Stamp Act 1891.

⁶ [1907] 1 KB 116.

⁷ Above, at 122 - 123.

⁸ "Contract Certainty Code of Practice: Principles and guidance" (June 2007), available at http://www.abi.org.uk/Information/Business/Contract_Certainty.aspx. The guidance applies to general insurance. The following "pure protection" classes are specifically excluded: Private Medical Insurance, Term Assurance, Critical Illness and Income Protection. The guidance applies equally to reinsurance.

15.18 The second initiative was the Market Reform Contract (MRC) developed by the London Market Group. In 2007 this replaced (and renamed) the previous standard “Market Reform Slip”.⁹ The MRC is intended to be the only contract document. It should be available when the contract is agreed, and should contain all the terms. It represents a move away from the long-standing culture of slip and policy, towards a practice based on a single contract document.

IS MARKET PRACTICE COMPATIBLE WITH THE 1906 ACT?

15.19 In Issues Paper 9, we considered how far current market practice is compatible with the 1906 Act. In theory there is a problem. Under section 22, an insured without a policy may not prove the existence of an insurance contract, and is therefore unable to make a claim.

15.20 In practice, this outcome is highly unlikely. Since the abolition of stamp duty on marine policies in 1970, there have been no cases in which a marine insurer has refused to pay a claim because the insured cannot produce a written policy. In consultation, insurers stressed that they would never take such a point.

15.21 A policy is not defined in the Act, though it does need to meet two requirements:

(1) Under section 23 it must specify “the name of the assured, or of some person who effects the insurance on his behalf”.

(2) Under section 24(1) it must be signed “by or on behalf of the insurer”.

15.22 Before 1959, the Act set out other requirements (including that the policy must specify the subject matter and the sums insured), but these have been repealed.¹⁰

15.23 In Issues Paper 9, we noted cases from the 1920s which held that a policy should be a complete record of the contract,¹¹ but concluded that these were unlikely to be upheld today. We thought that a court would take a broad approach, and accept any document which was signed by or on behalf of the insurer and included the name of the insured or broker. Problems may arise, however, where the insurance contract was purely oral, or where the only available document was not signed, or did not include the name of the insured or broker.

⁹ For more information about the MRC, see the London Market Group’s website at http://www.londonmarketgroup.co.uk/index.php?option=com_content&view=category&id=41&Itemid=144.

¹⁰ Section 23 formerly required that a marine policy must specify four additional facts: the subject-matter insured and the risk insured against; the voyage, or period of time, covered by the insurance; the sum or sums insured; and the name or names of the insurers. These requirements however, were repealed by the Finance Act 1959.

¹¹ The cases deal with the assignment of insurance under a CIF contract: see *Donald H Scott v Barclays Bank* [1923] 2 KB 1; and see *Diamond Alkali Export Corp v Bourgeois* [1921] 3 KB 443.

- 15.24 In Issues Paper 9, we considered what is meant by the insurer's signature under section 24(1). In 2001 the Law Commission took a broad view: signatures could include digital signature, scanned manuscript signatures and typed names.¹² Since 2001, several cases have supported the view that typing one's name into a document will suffice, provided it evidences the necessary authenticating intention.¹³ The issue is however, not beyond doubt.
- 15.25 Another difficult issue is whether the policy document must be in tangible form. In 2001, the Law Commission said that a policy could not be an electronic document. This is because the 1906 Act gives a broker a lien over the policy and a lien can only attach to a tangible object. In Issues Paper 9, we examined this issue again and, along with the Scottish Law Commission, reached a different view.¹⁴ While it is still the case that a lien requires a tangible or, in Scots law, corporeal object, a policy may exist, even if it is not in a form that the broker can take a lien over. We concluded that a marine policy within the meaning of section 22 may be an electronic document.

THE CASE FOR REFORM

- 15.26 In Issues Paper 9, we argued that it was damaging to have a law which was widely ignored and clearly divorced from market practice. It undermines the esteem in which the law is held, and gives rise to potential uncertainties. It makes it difficult to justify English and Scots law to an international audience. Given that the rationale for section 22 has disappeared, we thought that it was difficult to defend its continued existence.

Should marine insurance contracts meet statutory formalities?

- 15.27 We considered whether there should be any statutory requirements that marine insurance contracts should be in a particular form.
- 15.28 It is clearly good practice for insurers and insureds to put a complete set of contract terms in writing. This is an essential part of the drive towards contract certainty, reducing the possibilities for misunderstandings, disputes and fraud.
- 15.29 The question is not whether written contracts are desirable, but whether they should be required. If a formality is required, it is almost inevitable that someone, somewhere will fail to comply with it. The issue is what consequences should flow from this failure. Some consequences are inappropriate and harsh. Section 22 is particularly inappropriate: if taken literally, the section means that if an insurer has failed to issue a policy the insured is unable to prove the contract and therefore unable to make any claims under it.

¹² Law Commission, *Electronic Commerce: Formal Requirements in Commercial Transactions* (December 2001), Part 3. See also Scottish Law Commission, *Report on Land Registration*, Scot Law Com No 222, Part 34, which touches on these issues. Note also that, to facilitate the introduction of a limited form of electronic conveyancing in Scotland, an order under s 8 of the *Electronic Communications Act 2000* was regarded as necessary; see the *Automated Registration of Title to Land (Electronic Communications) (Scotland) Order 2006*, SSI 2006/491.

¹³ *Mehta v J Pereira* [2006] EWHC 813 (Ch); *Orton v Collins* [2007] EWHC 803 (Ch); *Lindsay v O'Loughnane* [2010] EWHC 529 (QB).

¹⁴ Issues Paper 9, para 4.14 and following. In reaching this view we were much helped by the Lloyds opinion; Opinion for Lloyd's legal team (January 2007).

- 15.30 We considered other possible sanctions, such as a criminal penalty or civil sanction on the insurer. This has the potential, however, to add a burden on business, and we do not think it appropriate in primary legislation. Instead, we thought that contract certainty is best left to the market, backed where necessary by regulation by the FSA or its successor.
- 15.31 We also considered whether it should be possible to have an enforceable oral contract for marine insurance. Under the 1906 Act, oral contracts are unenforceable. We cannot think of any way in which an insured under an oral contract can circumvent the effects of section 22. Yet it might be useful for the parties to agree cover over the phone to take effect immediately, and to send the paperwork at a later date.
- 15.32 Our tentative view therefore, was that legislation should not impose any formal requirements on marine insurance contracts. Instead, the normal contract rules of contract formation and evidence should apply. We concluded that section 22 should be repealed, together with four linked provisions: section 23, section 24(1), section 89 and Schedule 1, and asked for views.

Consultees' views

- 15.33 We received nine responses to Issues Paper 9. Industry representatives told us that the requirement has no practical effect in today's market. As the British Insurance Brokers' Association (BIBA) put it, "section 22 is widely ignored". The International Underwriters' Association (IUA) said it was no longer "fit for purpose", indicating that:
- the market has essentially moved away from the formal requirement to produce a policy and generally does not rely upon section 22 in contract disputes.
- 15.34 Seven consultees agreed that there should be no statutory requirements for marine insurance contracts to be in any particular form. Most consultees thought that, while it was desirable for formal records to be kept, primary legislation was not necessary. The Lloyd's Market Association said that the issue of contract documentation standards should be left to the market. Furthermore, five consultees (including the Association of British Insurers and IUA), said that they could see no reason for having a special rule for marine insurance that did not apply to non-marine insurance.
- 15.35 Of the remaining two respondents, BIBA thought that there should be written evidence of the contract and that it should be signed. They thought that section 22 should be retained and updated to reflect electronic trading.
- 15.36 Finally, the General Council of the Bar identified two schools of thought among practitioners. One view was that statutory formalities were unnecessary. There was no requirement for non-marine insurance to be in writing, and no logical basis for treating marine and non-marine insurance differently. The other view was that marine insurance contracts should be in a formal written document, even if this was not a "policy" as such. This would encourage sound commercial practices and reduce disputes.

CONCLUSION

- 15.37 Section 22 was enacted to prevent stamp duty evasion. As stamp duty on policies was abolished in 1970 it no longer serves any purpose. The distinction in the Marine Insurance Act 1906 between slips and policies does not correspond to contemporary market practice. If the Marine Insurance Act 1906 is to be reformed, the opportunity should be taken to remove the requirement for a formal marine policy.
- 15.38 We do not think that the statute should require marine insurance to be in any particular form. Although it is clearly desirable to put contract terms in writing, this should be a matter for the industry (backed if necessary by regulation). Most consultees agreed that statutory requirements for formality have the potential to cause problems.
- 15.39 We propose the repeal of section 22 along with associated provisions, including sections 23, 24(1), 89 and the model policy referred to in section 30 and contained in the First Schedule. Care must however, be taken. The distinction between a contract, slip and policy runs throughout the 1906 Act, and repealing one provision has implications for others. In Part 16, we discuss in detail the implications of repealing section 22 on other sections of the Act.
- 15.40 In Part 17 we return to the issue and make proposals in relation to each section separately, to ensure that the repeals we propose do not have unintended consequences.

PART 16

REPEALING SECTION 22: IMPLICATIONS FOR OTHER PROVISIONS IN THE 1906 ACT

- 16.1 As we noted in Part 15, the Marine Insurance Act 1906 makes an important conceptual distinction between an insurance “contract” and an insurance “policy”. The earlier sections of the Act mostly talk about the contract. For example, in section 17, “a contract of marine insurance is a contract based on utmost good faith”. Similarly, under sections 18 to 20 the assured has obligations to the insurer “before the contract is concluded”.
- 16.2 By contrast, the provisions which follow section 22 largely refer to policies. In all, the 1906 Act makes 166 references to the word “policy” or “policies”. Section 90 states that “unless the context or subject-matter otherwise requires ... ‘policy’ means a marine policy”. This directly links every mention of the word “policy” throughout the 1906 Act with the concept of a “marine policy” in section 22.

WHERE “POLICY” MEANS “CONTRACT”

- 16.3 In Issues Paper 9 we explained that most references to “a policy” within the 1906 Act simply mean a contract which may be enforced by the insured. We gave some examples.
- 16.4 The first example is the rule on double insurance, set out in section 32. This section applies “where two or more policies are effected by or on behalf of the insured”. When the Act was drafted, insureds could only be doubly insured if they possessed at least two insurance policies against the same event. This is because an insured who had entered into an insurance contract but who did not possess a policy was not able to prove the contract and therefore could not claim. Without at least two policies, the insured did not have two enforceable contracts. If section 22 were to be repealed, however, an insured could have an enforceable insurance contract without a policy. The word “policy” could simply be replaced by “contract”.
- 16.5 A second example is section 39 which states that “in a voyage policy” there is an implied warranty of seaworthiness. Again, it would be odd if the implied warranty only applied where a specific policy was issued. We think it should apply to all enforceable marine insurance contracts, whether or not a specific policy was issued.
- 16.6 In most cases therefore, references to policies in the 1906 Act may simply be interpreted as references to contracts.

WHERE “POLICY” MEANS “A POLICY DOCUMENT”

- 16.7 There are however, four sections where the word “policy” does not simply mean “contract”, but instead is used to refer to a specific document. The sections are 2(2), 30, 50(3) and 52. We think they need more discussion. Below we look at each of these provisions, in the order in which they appear in the 1906 Act.

SECTION 2(2): ACTIVITIES ANALOGOUS TO A MARINE ADVENTURE

16.8 Sections 1 to 3 define “marine insurance”. Section 1 defines it as insurance against “the losses incident to marine adventure”. Under section 3 there is said to be a marine adventure when ships, goods or other property are exposed to “maritime perils”, that is “the perils consequent on, or incidental to, the navigation of the sea”. Section 2(1) states that marine insurance may be extended (by express terms or custom) to “losses on inland waters” or “any land risk which may be incidental to any sea voyage”.

16.9 For our purpose, the relevant words are in section 2(2):

Where a ship in course of building, or the launch of a ship, or any adventure analogous to a marine adventure, is covered by a policy in the form of a marine policy, the provisions of this Act, in so far as applicable, shall apply thereto.

16.10 Thus the parties may extend the provisions of the Act to shipbuilding or “analogous” adventures if the contract is embodied in a document which takes the “form of a marine policy”.

“In the form of a marine policy”

16.11 The problem is that “a marine policy” does not have to take any particular form. As we have seen, under the Act all that is required is that the policy states the name of the assured and is signed by or on behalf of the insurer. Many non-marine policies would do this: we do not think this would be enough to take “the form of a marine policy”. As Mr Justice Mustill observed in *The Captain Panagos DP* in relation to this phrase:

What these words mean, I do not know.¹

16.12 The issue arose in a case from British Columbia.² In *James Yachts Ltd v Thames & Mersey Marine Insurance*,³ a ship in the course of construction was insured under a builders’ risk policy. This was found to be “the normal form of insurance for boat yards to cover ships and boats in the course of construction”. Mr Justice Ruttan found that a builders’ risk policy was marine insurance on the ground that it was generally understood to be so:

Builders’ risk policies are clearly covered by the Act as marine insurance All the textbooks on marine insurance refer to builders’ risk policies I am satisfied that this policy is in form and substance one of marine insurance and was so understood by both plaintiff and defendants.⁴

¹ *Continental Illinois National Bank and Trust Co of Chicago and Xenofon Maritimes SA v Alliance Assurance Co Ltd, “Captain Panagos DP”* [1989] 1 Lloyd’s Rep 33 CA.

² Under the materially identical provisions of the Marine Insurance Act of British Columbia 1960.

³ [1979] 1 Lloyd’s Rep 206.

⁴ At p 207 col 2 - p 208 col 1.

- 16.13 We can understand the logic that shipbuilding insurance should be treated as marine insurance if the parties understand it to be marine insurance. However, it is difficult to reconcile this with the words of section 2(2). The section does not state that shipbuilding insurance is marine insurance if it is in the form of a shipbuilding policy. It must be in the form of a “marine policy”, suggesting something different.

“Any adventure analogous to a marine adventure”

- 16.14 It is difficult to know how far the concept of “an analogous adventure” may extend.⁵ The issue was considered by the High Court of Australia in *Gibbs v Mercantile Mutual Insurance*,⁶ which suggested that navigation of inland waters would be analogous to a marine adventure.⁷
- 16.15 Section 3 states that marine perils arise from “navigation” of the seas. This raises the question of whether insurance of fixed platforms at sea is marine insurance. In *Promet Engineering (Singapore) v Sturge*,⁸ an insurance contract covering an offshore platform appears to have been assumed to be a marine insurance contract, even though it did not involve navigation. It might, however, be more accurate to see it as analogous to a marine adventure.
- 16.16 The concept may be wider still. The 1906 Act was enacted before the commercial exploitation of air travel.⁹ It may be that section 2(2) is confined to activities involving ships or water, but insurers have told us that that a modern air journey is seen as analogous to a marine adventure in 1906. On this basis, it is possible that air cargo insurance could be treated as marine insurance.

“In so far as applicable”

- 16.17 A further uncertainty under section 2(2) is that even if the analogous adventure is in the form of a marine policy, the provisions of the 1906 Act only apply “in so far as applicable”. Each provision needs to be considered on a case by case basis.
- 16.18 In *Netherlands v Youell*,¹⁰ the Court of Appeal considered whether section 78(4) applies to a shipbuilding insurance contract. This imposes a duty on the assured and its agents to take such measures as may be reasonable for the purpose of averting or minimising a loss. The Dutch navy entered into a contract with a shipyard to construct submarines. The navy procured insurance for its own benefit and that of the shipbuilders. The shipyard was negligent in the execution of the works, and the navy claimed under the insurance contract. The issue was whether the shipyard should have averted or minimised the loss.

⁵ F D Rose, *Marine Insurance* (2004) at para 1.31.

⁶ [2003] HCA 39. The case concerned section 8(2) of the Australian Marine Insurance Act 1909, which is written in identical terms.

⁷ Above at [12].

⁸ [1996] CLC 294 (Commercial Court); [1997] CLC 666 (CA).

⁹ Louis Blériot did not complete the first crossing of a body of water in a heavier-than-air aircraft until 1909.

¹⁰ [1998] CLC 44.

- 16.19 The Dutch navy ultimately succeeded on the ground that the shipyard was not its agent, so any comments made regarding the effect of section 2(2) were non-binding. Lord Justice Phillips took the view that section 2(2) did not make section 78(4) applicable to a shipbuilding insurance contract. He observed:

The duty of agents to sue and labour referred to in section 78(4) is a duty that arises in relation to a maritime adventure by reason of the delegation to master, crew and other agents of the conduct of that adventure. I can see no scope for the application of such a duty in relation to an assured who insures as the purchaser of ships under a shipbuilding contract.¹¹

- 16.20 Lord Justice Buxton disagreed,¹² and the third judge, Lady Justice Butler-Sloss, did not express a view.
- 16.21 The case shows that where section 2(2) is used, it is often difficult to know whether any particular provision of the 1906 Act applies to the contract. The parties may be better advised to include particular provisions within their contract expressly, rather than simply using the form of a marine policy, and leaving it to a court to decide which provisions may or may not be applicable.

Conclusion

- 16.22 Section 2(2) is a difficult provision to interpret, and it may lead to uncertain results. Now that marine insurance is no longer in the form of a specific stamped marine policy it is hard to give it meaning.
- 16.23 We think that its main purpose was to allow the parties to designate certain types of insurance as marine insurance if they wished to do so. In Part 17 we consider whether the reference to “a policy in the form of a marine policy” should be replaced by a reference to an express contract term. It would be open to the parties to apply the provisions of the 1906 Act as if the contract were one of marine insurance, in so far as the provisions were applicable. This would be a cautious approach, preserving the law as we best understand it to be.
- 16.24 The more radical option would be the repeal of the section, leaving the parties free to include any particular provisions of the 1906 Act they wished by express provision within the contract.

SECTION 30: THE MODEL POLICY UNDER SCHEDULE 1

- 16.25 Section 30 introduces a model marine insurance policy which the parties may use. It reads as follows:

Construction of terms in policy

- (1) A policy may be in the form in the First Schedule to this Act.

¹¹ Above, at 55.

¹² Above, at 56.

- (2) Subject to the provisions of this Act, and unless the context of the policy otherwise requires, the terms and expressions mentioned in the First Schedule to this Act shall be construed as having the scope and meaning in that schedule assigned to them.
- 16.26 Schedule 1 sets out a model policy which the parties may use. The model policy is purely voluntary: there is no need for a marine policy to resemble the one in the Schedule.
- 16.27 We doubt very much that the model policy is ever used today. It is written in an archaic style, with many long sentences and old fashioned words. The first two paragraphs provide an indication of the style used:
- Be it known that _____ as well in _____ own name as for _____ and in the name and names of all and every other person or persons to whom the same doth, may, or shall appertain, in part or in all doth make assurance and cause and them, and every of them, to be insured lost or not lost, at and from _____
- Upon any kind of goods and merchandises, and also upon the body, tackle, apparel, ordnance, munition, artillery, boat, and other furniture, of and in the good ship or vessel called the _____ whereof _____ is master under God, for this present voyage, _____ or whosoever else shall go for master in the said ship, or by whatsoever other name or names the said ship, or the master thereof, is or shall be named or called; beginning the adventure upon the said goods and merchandises from the loading thereof aboard the said ship.
- 16.28 In Issues Paper 9, we proposed the repeal of section 30(1) and the model policy. This was not controversial.
- 16.29 The model policy is then followed by rules of construction to be used “for the construction of a policy in the above or other like form, where the context does not otherwise require”. The rules define such words as “safely landed”, “pirate” and “thief” and, unlike the policy, are written in a simple, direct style.
- 16.30 Three consultees told us that while the model policy is not used, the rules of construction continue to be relevant. Marsh and Guy Carpenter said that “the terms appear in Institute Clauses and elsewhere in marine insurance contracts.”¹³ The General Council of the Bar also said that numerous terms used in the Lloyd’s SG form of policy in Schedule 1 have benefitted from the courts’ interpretation for the better part of two centuries and they are still used.
- 16.31 It is clear that the rules of construction are no longer linked to the model policy, but are used widely by the industry. If section 30(1) and the model policy were to be repealed, it would be important to retain the rules of construction.

¹³ Institute Clauses are model clauses which may be incorporated into a marine insurance contract and are now issued by the Joint Committees of the International Underwriting Association and the Lloyd’s Market Association. Such clauses exist, amongst others, for hull and machinery, cargo, war, various commodities and voyages. Institute Clauses, in the same way as other clauses, set out risks covered, together with other terms of business relevant to the scope of cover provided and the obligations on the insured.

SECTION 50(3): ASSIGNING A POLICY

16.32 Section 50 of the 1906 Act reads as follows:

When and how policy is assignable

- (1) A marine policy is assignable unless it contains terms expressly prohibiting assignment. It may be assigned either before or after loss.
- (2) Where a marine policy has been assigned so as to pass the beneficial interest in such policy, the assignee of the policy is entitled to sue thereon in his own name; and the defendant is entitled to make any defence arising out of the contract which he would have been entitled to make if the action had been brought in the name of the person by or on behalf of whom the policy was effected.
- (3) A marine policy may be assigned by indorsement thereon or in other customary manner.

16.33 The word “policy” as used in sections 50(1) and (2) simply means contract. However, section 50(3) envisages a paper document that can be indorsed. This form of assignment (or, in Scots law, assignation) was an important feature in goods contracts, particularly CIF contracts.

16.34 CIF stands for “cost, insurance and freight”, and is a common form of international trade contract. The key feature is that the seller ships goods at his own expense and insures them under a policy of marine insurance.¹⁴ The seller transfers its rights under the contract of carriage and insurance by making any necessary indorsements and by delivering the bill of lading, the insurance policy or certificate and other shipping documents, on which event the risk shifts to the buyer.¹⁵ Assignment of the policy under section 50 is essential to performance of a CIF contract.

16.35 Traditionally assignment was “in blank”. In *J Aron & Co v Miall*,¹⁶ the original insured assigned the benefit of the policy to the first purchaser of the goods. The insured’s broker and the purchaser’s agent both signed their names on the policy. The effect was to assign the right to claim to whoever held the policy at the time. In addition, “it was made more precise in this case by the plaintiffs, the holders of the policy, endorsing on it a request that the claim be paid to them”.¹⁷ The entire benefit of the insurance, covering both future and past losses, passes to the assignee.¹⁸

¹⁴ The seller may also buy the goods afloat, shipped and insured.

¹⁵ *Johnson v Taylor Bros & Co Ltd* [1920] AC 144 at 155 – 156, by Lord Atkinson.

¹⁶ *J Aron & Co v Miall* [1928] All ER Rep 655.

¹⁷ Above, at 657, by Lord Justice Scrutton.

¹⁸ *Williams v Atlantic Assurance Co Ltd* [1933] 1 KB 81; *First National Bank of Chicago v West of England Shipowners Mutual Protection and Indemnity Association (Luxembourg)*, *The Evelpidis Era* [1981] 1 Lloyd’s Rep 54 at p 64.

The need for a full policy

- 16.36 In a CIF contract, there is an implied term that the seller tenders to the buyer a marine policy with the shipping documents.¹⁹ Several early twentieth century cases held that to comply with this term, there must be a proper policy containing all the terms of the insurance on its face, or which refers to a readily accessible document in which such terms are contained. As Lord Justice Atkin said in *Donald H Scott & Co Ltd v Barclays Bank Ltd*:

One may very reasonably object to a document which comes masquerading as a policy of insurance, that on closer inspection it does not really purport to be a policy at all but only a certificate that a policy has been issued.²⁰

- 16.37 In *Manbre Saccharine v Corn Products Ltd*,²¹ the document was a letter stating “we hold you harmless in the sum of... in accordance with the terms of the... certificate of insurance”, signed by the insurer. Holding that this was not a valid tender, the judge said:

There is a wide difference between an actual policy of assurance transferable to the plaintiffs as contemplated by section 50(3) of the Marine Insurance Act 1906, and such a letter as that of the defendants here.

- 16.38 Section 50(3) of the 1906 Act therefore, contemplated an actual policy with all the terms, rather than some other document.²²

Current market practice

- 16.39 As might be expected, market practice has changed over the last 80 years. We understand that, for many years, it was common for the seller under a CIF contract to indorse a certificate of insurance rather than the full policy.

- 16.40 More recently, there has been a move away from paper documents altogether. We were told by a leading cargo insurer that under their contractual terms of insurance the assured includes not only the name stated in the schedule but also “any party to whom insurable interest in the subject matter insured hereunder passes under a contract of sale”. This means that the insurance is assigned automatically as soon as insurable interest in the goods passes. All that is required is that the assignor provides the assignee with details of the cover.

¹⁹ *Biddell Brothers v E Clemens Horst Co* [1911] 1 KB 214 at p 221. This point was not overturned on final appeal; *Biddell Brothers v E Clemens Horst Co* [1912] AC 18.

²⁰ [1923] 2 KB 1 at 20.

²¹ [1919] 1 KB 198.

²² See also *Wilson, Holgate & Co v Belgian Grain and Produce* [1920] 2 KB 1, where a broker’s cover note was held not to be a valid tender of a policy under a CIF contract. Note also that in *Diamond Alkali Export Corp v Bourgeois* [1921] 3 KB 443, the judge rejected the argument that a certificate of insurance was a valid tender under a CIF contract, expressing the view that the meaning of “policy” under s 50(3) and s 22 was the same.

Conclusion

- 16.41 From our discussions with the industry it appears that marine insurance contracts are no longer assigned by indorsing copies of the full policy. In some cases, the contract may be assigned by indorsing a paper copy of the insurance certificate, but this is now giving way to electronic commerce. We think that section 50(3) could be amended to say that a marine insurance contract may be assigned in any customary manner or as agreed between the parties to the transfer. In Part 17 we ask for views on this issue.

SECTION 52

- 16.42 Section 52 of the Marine Insurance Act 1906 provides:

When premium payable

Unless otherwise agreed, the duty of the assured or his agent to pay the premium, and the duty of the insurer to issue the policy to the assured or his agent, are concurrent conditions, and the insurer is not bound to issue the policy until payment or tender of the premium.

- 16.43 We did not discuss this section in Issues Paper 9. The matter was however, raised by the General Council of the Bar in their response. They pointed out that if section 22 were repealed but section 52 remained, the insurer may still be required to issue a written record of the contract.
- 16.44 The provision has attracted no significant comment from judges, practitioners or academics. The authors of Halsbury's Laws comment that it is not easy to ascertain what effect this provision was intended to have.²³
- 16.45 We agree that the purpose of section 52 is far from clear. Presumably, at a time when the insured needed a policy to make a claim it introduced a default rule into the law: the insurer was not obliged to pay a claim until the premium had been paid. It was, however, open to the parties to contract out of this provision. We think that, even in 1906, it was common for insurers to go on risk before receiving premiums.
- 16.46 The provision does not appear to have any contemporary relevance. In Part 17 we propose its repeal.

²³ Vol 25 (2003 reissue), Insurance, at para 271, fn 1.

PART 17

THE NEED FOR A MARINE POLICY: PROPOSALS FOR REFORM

- 17.1 If the 1906 Act is to be reformed, we think the opportunity should be taken to remove the need for a contract of marine insurance to be embodied in a marine policy. The requirement was introduced to prevent the evasion of stamp duty, and since stamp duty on marine policies has been abolished, it has no rationale. The provision is widely ignored, but continues to have the potential to cause problems.
- 17.2 Although it is good practice for the parties to put all the terms of the contract in writing,¹ we do not think that statute should require a contract to take any particular form.
- 17.3 **Do consultees agree that:**
- (1) a marine insurance contract may be enforced even if it is not embodied in a formal policy document?**
 - (2) the statute should not require a marine insurance contract to be in any particular form?**
- 17.4 Many of the repeals and reforms we recommend are minor and technical. They are however, quite extensive and affect ten separate provisions of the 1906 Act. It is important that none of the proposed changes have unforeseen consequences. We therefore describe the provisions and set out our proposals in relation to each of them. We start by considering the provisions which we think should be repealed, and then consider the provisions which we think should be amended.

REPEALS

Section 22: contract must be embodied in a policy

- 17.5 The section states that a marine insurance contract is only admissible in evidence if it is embodied in a marine policy:

Subject to the provisions of any statute, a contract of marine insurance is inadmissible in evidence unless it is embodied in a marine policy in accordance with this Act. The policy may be executed and issued either at the time when the contract is concluded, or afterwards.

- 17.6 We propose the repeal of this section.
- 17.7 **Do consultees agree that section 22 should be repealed?**

¹ "Contract Certainty Code of Practice: Principles and guidance" (June 2007), available at http://www.abi.org.uk/Information/Business/Contract_Certainty.aspx.

Section 23: name of the insured

17.8 Section 23 states that a policy must include the name of the insured or broker. It reads as follows:

A marine policy must specify—

(1) The name of the assured, or of some person who effects the insurance on his behalf.

17.9 In Part 11, we considered the history of this provision, which originated as a way of checking whether the assured had an insurable interest in the subject matter of the insurance. We do not think that it has been effective in meeting this goal. Section 23 permits an insurance policy to contain the name of the broker rather than the insured, which would not give any indication of the insurable interest. As we discuss in Part 12, we do not think that there is any reason to preserve it.

17.10 Furthermore, without section 22, section 23 has no purpose. We therefore propose its repeal.

17.11 **Do consultees agree that section 23 should be repealed?**

Section 24(1): signed by insurer

17.12 Section 24(1) requires that a policy is signed by or on behalf of the insurer:

(1) A marine policy must be signed by or on behalf of the insurer, provided that in the case of a corporation the corporate seal may be sufficient, but nothing in this section shall be construed as requiring the subscription of a corporation to be under seal.

17.13 We propose the repeal of this section.

17.14 **Do consultees agree that section 24(1) should be repealed?**

Section 89: slip as evidence

17.15 Section 89 confirms that once the policy is provided, the court may also consider the slip:

Where there is a duly stamped policy, reference may be made, as heretofore, to the slip or covering note, in any legal proceeding.

17.16 We propose the repeal of this section.

17.17 **Do consultees agree that section 89 should be repealed?**

Section 30: model policy

17.18 Section 30 introduces a schedule to the 1906 Act, which is in two parts. It includes a model policy, written in an archaic style, which is no longer used. It also sets out rules of construction, which continue to be relevant. The section reads as follows:

(1) A policy may be in the form in the First Schedule to this Act.

- (2) Subject to the provisions of this Act, and unless the context of the policy otherwise requires, the terms and expressions mentioned in the First Schedule to this Act shall be construed as having the scope and meaning in that schedule assigned to them.
- 17.19 The rules of construction in section 30(2) are not dependent on the use of the model policy. As we discuss in Part 16, they are often used without the model policy. We propose that section 30(1) should be repealed, but that the rules of construction should be retained.
- 17.20 **Do consultees agree that the model policy referred to in section 30 and contained in the First Schedule should be repealed?**

Section 52: policy to be issued when premium paid

- 17.21 Section 52 states that the insurer is not bound to issue a policy until the insured pays the premium. It provides:
- Unless otherwise agreed, the duty of the assured or his agent to pay the premium, and the duty of the insurer to issue the policy to the assured or his agent, are concurrent conditions, and the insurer is not bound to issue the policy until payment or tender of the premium.
- 17.22 As we discussed in Part 16, once the requirement for a marine policy has been removed, the insurer will no longer be bound to issue a policy at all. We propose that the section should be repealed.
- 17.23 **Do consultees agree that section 52 should be repealed?**

REFORMS

Where policy means contract

- 17.24 As we discussed in Part 16, the 1906 Act makes 166 references to “policy” or “policies”. According to section 90, “‘policy’ means a marine policy”, linking each mention of the word “policy” to the requirement to issue a policy under section 22.
- 17.25 In the great majority of cases, the reference to a policy means a contract which is admissible in evidence under section 22 and therefore may be enforced. We think that the word “policy” may simply be replaced by the word “contract”. We could do this either by replacing the word each time it appears or, alternatively, we could change section 90 to state that a policy means a valid contract for marine insurance.
- 17.26 **Do consultees agree that most references to policies in the 1906 Act should be interpreted as references to marine insurance contracts?**

Section 2(2): activities analogous to a marine adventure

- 17.27 In Part 16 we described how an insurance contract which does not fall within the definition of marine insurance may be treated as marine insurance if it is in the form of a marine policy. This applies to insurance on shipbuilding or “any adventure analogous to a marine adventure”. The relevant words are in section 2(2):

Where a ship in course of building, or the launch of a ship, or any adventure analogous to a marine adventure, is covered by a policy in the form of a marine policy, the provisions of this Act, in so far as applicable, shall apply thereto.

- 17.28 We explained that the courts had found this a difficult provision to interpret. Now that marine policies do not have to be in any particular form, it is difficult to know what may be covered by the words “in the form of a marine policy”.
- 17.29 We think that the main purpose of section 2(2) was to allow the parties to designate certain types of insurance as marine insurance if they wished to do so. On this basis the sub-section could be re-written to say that where insurance is taken out on “a ship in course of building, or the launch of a ship, or any adventure analogous to a marine adventure”, the parties may include an express term to designate the insurance as marine insurance for the purposes of the 1906 Act. This would preserve the current law as far as possible. It should be noted that such a designation would only apply to the provisions of the 1906 Act. It would not designate the insurance as marine insurance for any other purpose.
- 17.30 Furthermore, section 2(2) would apply the provisions of the 1906 Act only “in so far as applicable”. These words have an element of tautology. The courts have found it difficult to know which provisions of the 1906 Act should apply to ship building and analogous contracts. The parties may be better advised not to use section 2(2), but to apply each of the provisions of the 1906 Act they wish to apply to the contract in specific terms. On this basis, section 2(2) could simply be repealed.
- 17.31 On balance, we propose to preserve the current law as closely as possible to allow the parties to designate shipbuilding and other contracts as marine insurance for the purposes of the 1906 Act. Nevertheless, we welcome views on the more radical option, namely the repeal of section 2(2).
- 17.32 **Do consultees agree that where an insurance contract covers shipbuilding, a ship launch or “any adventure analogous to a marine adventure”, the parties may include an express term to designate the insurance as marine insurance for the purposes of the 1906 Act? This would apply the provisions of the Act “in so far as applicable”.**
- 17.33 **Alternatively, should section 2(2) be repealed, leaving the parties free to apply any specific provision of the Act to the policy?**

Section 21: when contract concluded

- 17.34 Section 21 states that a contract is concluded when the insured’s proposal is accepted, even if the policy is issued later:

A contract of marine insurance is deemed to be concluded when the proposal of the assured is accepted by the insurer, whether the policy be then issued or not; and, for the purpose of showing when the proposal was accepted, reference may be made to the slip or covering note or other customary memorandum of the contract.

17.35 We think that the only important words here are the first two lines: “a contract of marine insurance is deemed to be concluded when the proposal of the assured is accepted by the insurer”. The remainder of the section, with references to policies, slips and cover notes is unnecessary, and potentially confusing. Instead, the normal rules of contract interpretation should apply.

17.36 **Do consultees agree that the following words should be removed?**

whether the policy be then issued or not; and, for the purpose of showing when the proposal was accepted, reference may be made to the slip or covering note or other customary memorandum of the contract.

Section 50(3): assigning a policy

17.37 Section 50(3) states that “a marine policy may be assigned by indorsement thereon or in other customary manner”.

17.38 It used to be common for sellers to assign cargo insurance contracts to buyers by indorsing a marine policy. We have been told that marine cargo insurance contracts are no longer assigned by indorsing copies of the full policy. In some cases, the contract may be assigned by indorsing a paper copy of the insurance certificate, but this is now giving way to electronic commerce. We propose to amend section 50(3) to say, quite simply, that a marine insurance contract may be assigned in any customary manner or as agreed between the parties to the transfer. We welcome views on this issue.

17.39 **Should section 50(3) be amended to say that a marine insurance contract may be assigned in any customary manner or as agreed between the parties to the transfer?**

17.40 **Are there any other issues or related matters which we should take account of in relation to our proposal to amend section 50(3)?**

PART 18

THE BROKER'S LIABILITY FOR PREMIUM: SECTION 53(1) OF THE MARINE INSURANCE ACT 1906

INTRODUCTION

- 18.1 Section 53(1) of the Marine Insurance Act 1906 makes a marine broker liable to pay the premium to the insurer, whether or not it has received payment from the insured. It reads as follows:

Unless otherwise agreed, where a marine policy is effected on behalf of the assured by a broker, the broker is directly responsible to the insurer for the premium, and the insurer is directly responsible to the assured for the amount which may be payable in respect of losses, or in respect of returnable premium.

- 18.2 The section codified a custom developed in the eighteenth and nineteenth centuries, to provide security to marine underwriters against unfamiliar policyholders. It overrides the normal rule of agency law that an agent is not personally liable on a contract effected for its principal.
- 18.3 At first sight, section 53(1) seems limited. It states that, in the absence of agreement to the contrary, the broker assumes the risk that the policyholder may not pay. Thus the broker becomes liable in the event of the policyholder's insolvency.
- 18.4 There may however, be more to section 53(1) than meets the eye. There is uncertainty over how far nineteenth-century cases are relevant to interpreting section 53(1). If they are relevant, they may lead to some surprising results. It is likely that where section 53(1) applies, the insurer has no right to claim the premium from the policyholder: only the broker may sue the policyholder for the premium. There is also some question about how far section 53(1) allows an insurer to rely on a payment default clause.
- 18.5 As we discussed in Issues Paper 8, the interpretation of section 53(1) is fraught with complexity and uncertainty. Although it appears to protect insurers against the policyholder's insolvency, it may not always provide the protection insurers expect. Furthermore, if a marine broker becomes insolvent, insurers may face unexpected risks. In particular, the case law underlying section 53(1) appears to state that the insured pays a broker as principal rather than as agent. This has the potential to undermine Financial Services Authority (FSA) protections on client money.
- 18.6 In this Part we describe current market practice, before outlining the various risks and uncertainties lying behind section 53(1). In Part 19 we set out the case for reform.

COLLECTING PREMIUMS: CURRENT MARKET PRACTICE

- 18.7 In Issues Paper 8, we asked how far section 53(1) reflects current market practice. We were interested in how insurers collect premiums in the marine market (where section 53(1) applies) and the non-marine market (where it does not).
- 18.8 It is clear that in both markets insurers look to brokers for payment. They often collect premiums through systems of net accounting, which may debit the broker's account before the broker has received payment from the policyholder. This however, is different from making the broker personally liable to the insurer. Where net accounting systems are used in non-marine insurance, brokers would not pay the insurer if the policyholder terminates the agency,¹ becomes insolvent or indicates a refusal to pay. The broker's responsibility for premium is greater in marine insurance than in non-marine insurance.
- 18.9 Insurers and brokers normally have a Terms of Business Agreement (TOBA) in place, to regulate their relationship. It is therefore possible for a non-marine broker to assume personal responsibility for paying a premium to the insurer, as a result of a contractual commitment. This may happen, but is relatively rare.
- 18.10 We were told that the primary means by which insurers enforce premium collection is by inserting a payment default clause in the insurance contract. These take a variety of forms.² Typically, clauses provide that if the policyholder fails to pay by the due date, the insurer (or sometimes the broker) may cancel the contract. The Lloyd's Market Association (LMA) explained:
- We understand that the credit control departments of managing agents do rely on premium payment clauses and issue notices of cancellation on a regular basis (usually resulting not in cancellation but in actual payment).
- 18.11 The LMA told us that in the marine market insurers do occasionally invoke section 53(1) against brokers. The International Underwriting Association (IUA) agreed: while other methods of securing payment would be relied on in the first instance, section 53(1) provided insurers with a "useful additional protection". The Association of British Insurers also described the section as "additional protection" that was "justifiable" in marine insurance. Marsh and Guy Carpenter, the brokers, confirmed that "insurers do sometimes rely on section 53(1)".
- 18.12 Insurers explained to us that section 53(1) is particularly useful for short-term arrangements, where the premium is paid after the period of insurance and cancellation is no longer possible. We have not, however, been able to quantify its effect. We do not know how much premium marine brokers pay to insurers each year which cannot be reclaimed from policyholders.

¹ See *Pacific and General Co v Hazell* [1997] LRLR 65.

² Other possible premium default clauses include premium payment warranties or clauses making payment a condition precedent to the policy.

- 18.13 We appreciate that, in marine insurance, underwriters often know little about policyholders, which may be located anywhere in the world. Insurers are unable to assess policyholders' credit worthiness, and are not in a position to take legal action against them. The market therefore operates more quickly and smoothly if the risk is passed down the chain. The effect is that the underwriter claims against the placing broker, the placing broker claims against the producing broker, and the producing broker claims against policyholder.
- 18.14 Unfortunately, section 53(1) has so many hidden complexities that it may not perform the task that the market requires of it. It gives rise to two types of risk:
- (1) Where the policyholder is insolvent, it may not cover all the circumstances in which insurers wish to invoke it against brokers.
 - (2) Where the broker is insolvent, it has uncertain, and possibly surprising, results.
- 18.15 Below we attempt to summarise the complexities and risks which lie behind section 53(1). This is not an easy task. The effect of the section is so uncertain that our views on its meaning and its interpretation can only be tentative. This uncertainty is, in itself, a good reason to reform it.

POLICYHOLDER INSOLVENCY: THE LIMITS OF SECTION 53(1)

- 18.16 In discussions, insurers provided us with examples of the sort of case where section 53(1) may be useful to them. We are concerned that the section may not apply in some of the examples they provided. The section has three limitations:
- (1) It only applies to marine insurance;
 - (2) It may not cover adjusted premium clauses; and
 - (3) It is uncertain whether it applies to insurance contracts written under foreign law.
- 18.17 Below we look at each limitation in turn.

Section 53(1) only applies to marine insurance

- 18.18 In Issues Paper 8, we explained that section 53(1) is “almost certainly now limited to the marine insurance market”³ following the decision in *Pacific and General Insurance Co v Hazell*.⁴ Although the case is not decisive, most commentators agree that it would be difficult to argue that the section applies to non-marine insurance.⁵ A leading textbook concludes that the section is “inapplicable to non-marine business”.⁶
- 18.19 This means that section 53(1) only applies if the insurance falls within the definition of marine insurance set out in sections 1 to 3 of the 1906 Act. We have discussed some of the technicalities of these sections in Part 16.⁷ It is not at all clear that insurance on fixed marine platforms or air cargo meets the definition in these sections.

Adjusted premium clauses

- 18.20 In most insurance, the amount of the premium is fixed from the start. Some marine policies, however, contain clauses which provide for premiums to be increased. Thus the insurer may charge higher premiums where a vessel enters a war zone or when the volume of goods shipped on board is greater than originally anticipated. These sums are often collected in arrears, so the insurer is unable to cancel the policy if the sums are not paid. Insurers suggested that section 53(1) would provide helpful additional protection in these circumstances, to give the insurer the right to collect adjusted premiums from the broker.
- 18.21 There is, however, authority to suggest that section 53(1) does not apply to adjusted premium clauses. In *The Litsion Pride*,⁸ additional premiums became payable if the vessel entered a war zone. Mr Justice Hirst held that section 53(1) did not apply to these sums.

³ Issues Paper 8, paras 2.24 to 2.43.

⁴ [1997] LRLR 65.

⁵ Dame Elizabeth Gloster has suggested, extrajudicially, that in reality, “it would be impossible to raise such an argument again”. See “Who pays the piper – who calls the tune? Recent issues arising in the context of section 53 of the Marine Insurance Act 1906” [2007] *Lloyd’s Maritime and Commercial Law Quarterly* 302, at p 314.

⁶ *MacGillivray on Insurance Law* (11th ed 2008), at para 35-013. See also R Merkin, *Colinvaux’s Law of Insurance* (8th ed 2006), at para 1-12 (difference (j)).

⁷ See paras 16.8 and following.

⁸ *Black King Shipping Corporation and Wayang (Panama) SA v Mark Ranald Massie (The Litsion Pride)* [1985] 1 Lloyd’s Rep 437, at pp 510 and 512. The section 53 point was raised in the context of the policyholder’s argument that it had not breached a duty of disclosure by failing to disclose the vessel’s arrival in a war zone. The argument was that, because section 53 applied, the duties of disclosure were owed to the broker and not to the insurer. Hirst J rejected this argument and held that section 53 did not apply, which meant that the duty of disclosure was still owed to the insurer. (*The Litsion Pride* was overruled by *The Star Sea* [2001] UKHL 1, [2003] 1 AC 469 on other grounds).

- 18.22 In Issues Paper 8, we summarised the criticisms made of this ruling.⁹ Dame Elizabeth Gloster has expressed doubt that it would be followed today.¹⁰ Nevertheless, the decision casts uncertainty over this area.

Insurance contracts written under foreign law

- 18.23 Another uncertainty is whether section 53 applies to a contract of insurance which is written in the United Kingdom (at Lloyd's, for example) but is made subject to the law of a foreign jurisdiction.
- 18.24 Professor Merkin takes the view that section 53(1) would continue to govern the relationship between the broker and the insurer, even if English law did not apply to the insurance policy itself. He argues that the custom underlying section 53(1) "arises out of the market relationship between the broker and the underwriters and not out of the surrounding contracts".¹¹
- 18.25 That said, section 53(1) only applies "where a marine policy is effected on behalf of the assured". This may require that the marine policy be effected under English or Scots law. Furthermore, the section goes on to say that the insurer is directly responsible to the assured for losses; this can only apply to contracts written under English or Scots law. As we discuss below, the broker's liability to pay is an integral part of a more general scheme governing liabilities between insurer, policyholder and broker. We think this general scheme should be seen as part of the law governing the contract of insurance, not simply the relations between broker and insurer. On this basis, it would appear that section 53(1) only applies to contracts written under English or Scots law.

Conclusion

- 18.26 For these three reasons, insurers may gain less protection from section 53(1) than first appears. Insurers routinely agree TOBAs with brokers. In many cases, it would be better for insurers and brokers to agree appropriate terms among themselves than to rely on the uncertainties of the section.

BROKER INSOLVENCY

- 18.27 A major concern is how section 53(1) applies if the broker becomes insolvent. It is likely that the section has to be interpreted according to the case law which lies behind it. If so, it may have surprising effects, undermining both TOBAs and statutory protections for client money.

⁹ Insurance Contract Law Issues Paper 8: The Broker's Liability for Premiums: Should Section 53 be Reformed? (July 2010), at para 3.6.

¹⁰ E Gloster, "Who pays the piper – who calls the tune? Recent issues arising in the context of section 53 of the Marine Insurance Act 1906" [2007] Lloyd's Maritime and Commercial Law Quarterly 302, at p 311.

¹¹ R Merkin, *Colinvaux's Law of Insurance* (8th ed 2006), at para 23-74, n 5.

18.28 Here we begin by outlining the case law behind section 53(1) and its potential problems. We then provide a brief summary of the effect of broker insolvency on premium payment in non-marine insurance, where section 53(1) does *not* apply. This allows us to compare how the outcome under section 53(1) may differ. We conclude that insurers may be at greater risk where section 53(1) applies than where it does not.

The case law behind section 53(1)

18.29 The 1906 Act codified case law developed over the eighteenth and nineteenth centuries. The leading case in this area is a Court of Appeal decision from 1897, *Universo Insurance Co of Milan v Merchants Marine Insurance Co Ltd*.¹² In *Universo* a reinsurer attempted to claim the premium due to it from the policyholder rather than from the broker, which had become insolvent. The Court of Appeal rejected the claim on the ground that, by established custom, the policyholder owed the premium to the broker, not to the insurer. Lord Justice Chitty explained the law in the following terms:

The established custom in marine insurance effected through a broker is that the assured is not, and that the broker is, liable to the underwriter for the payment of the premium. The ground of the custom appears to be that in most cases the assured is not, and the broker is, known to the underwriter, and, accordingly, that the underwriter gives credit to the broker alone; and that there is an account between the broker and the underwriter in which credit is given for the payment of the premium. In order to sustain this course of business, and to enable the underwriter to recover from the broker the premium, when it is not in fact paid, it is considered in law that the premium has been paid to the underwriter by the broker, and that the underwriter has lent the premium to the broker.¹³

18.30 The case establishes three propositions:

- (1) The broker is directly liable to the insurer for the premium;
- (2) The insured is directly liable to the broker for the premium; and
- (3) The insured is not liable to pay premium to the insurer.

18.31 The first proposition is spelt out in the text of section 53(1). The other two propositions do not appear in the statute itself, but appear to lie behind the words of section 53(1). They were built on a fiction that the broker has already paid the underwriter, and the underwriter had lent the premium back to the broker.

¹² *Universo Insurance Co of Milan v Merchants Marine Insurance Co Ltd* [1897] 2 QB 93 at 99. There does not appear to be any Scottish case law or literature discussing either the custom underlying s 53(1) of the 1906 Act or s 53(1) itself.

¹³ Above at 99 to 100.

18.32 In Issues Paper 8, we discussed how far the *Universo* case may still be considered good law. The issue is open to doubt. We concluded, however, that section 53(1) is likely to be interpreted against its common law background, to establish that the insured is directly liable to pay premium to the broker, and is not liable to pay premium to the insurer.¹⁴

18.33 There is recent authority to suggest that the insured is still directly liable to the broker. In *J A Chapman & Co Ltd v Kadirga Denizcilik Ve Ticaret*,¹⁵ the broker had not paid the premium to the insurer and, as the broker was in liquidation, would probably never do so. Despite this, the policyholder remained liable to pay premiums to the broker. Sir Brian Neill commented:

As a general rule, the broker can recover premiums even if he has not yet paid them to the insurer.... It is true that section 53 of the 1906 Act does not deal expressly with the rights and liabilities between the broker and the assured.... But it was common ground that it is the *general* rule that the broker has a cause of action in his own right against the assured in respect of unpaid premiums.¹⁶

18.34 Since 1897, there is no direct authority to establish whether an insurer may sue a marine insured for premium. We note, however, the views of several commentators which suggest that *Universo* is still good law. As Professor Bennett comments:

Where marine insurance is placed through a broker, the insurer's sole right to premium lies against the placing broker. The assured has no liability to the insurer at all, even at a secondary level should the broker default.¹⁷

18.35 *MacGillivray* explains that:

So far as the Lloyd's broker and underwriter are concerned, the premium is treated as a debt due from the broker alone.¹⁸

18.36 This conclusion was endorsed by the High Court of Australia in 1986, when it interpreted section 59 of the Australian Marine Insurance Act 1909.¹⁹ Section 59 has now been repealed, but it used identical terms to section 53. The High Court of Australia held under section 59:

an insurer has no recourse against the assured if the broker defaults on payment of the premium.²⁰

¹⁴ Insurance Contract Law Issues Paper 8: The Broker's Liability for Premiums: Should Section 53 be Reformed? (July 2010), at paras 3.34 – 3.39.

¹⁵ [1998] Lloyd's Rep IR 377, [1998] CLC 860.

¹⁶ Above, at [862] and [865] (emphasis in original).

¹⁷ H N Bennett, *The Law of Marine Insurance* (2nd ed 2006), at para 6.25.

¹⁸ *MacGillivray on Insurance Law* (11th ed 2008), at para 35-013.

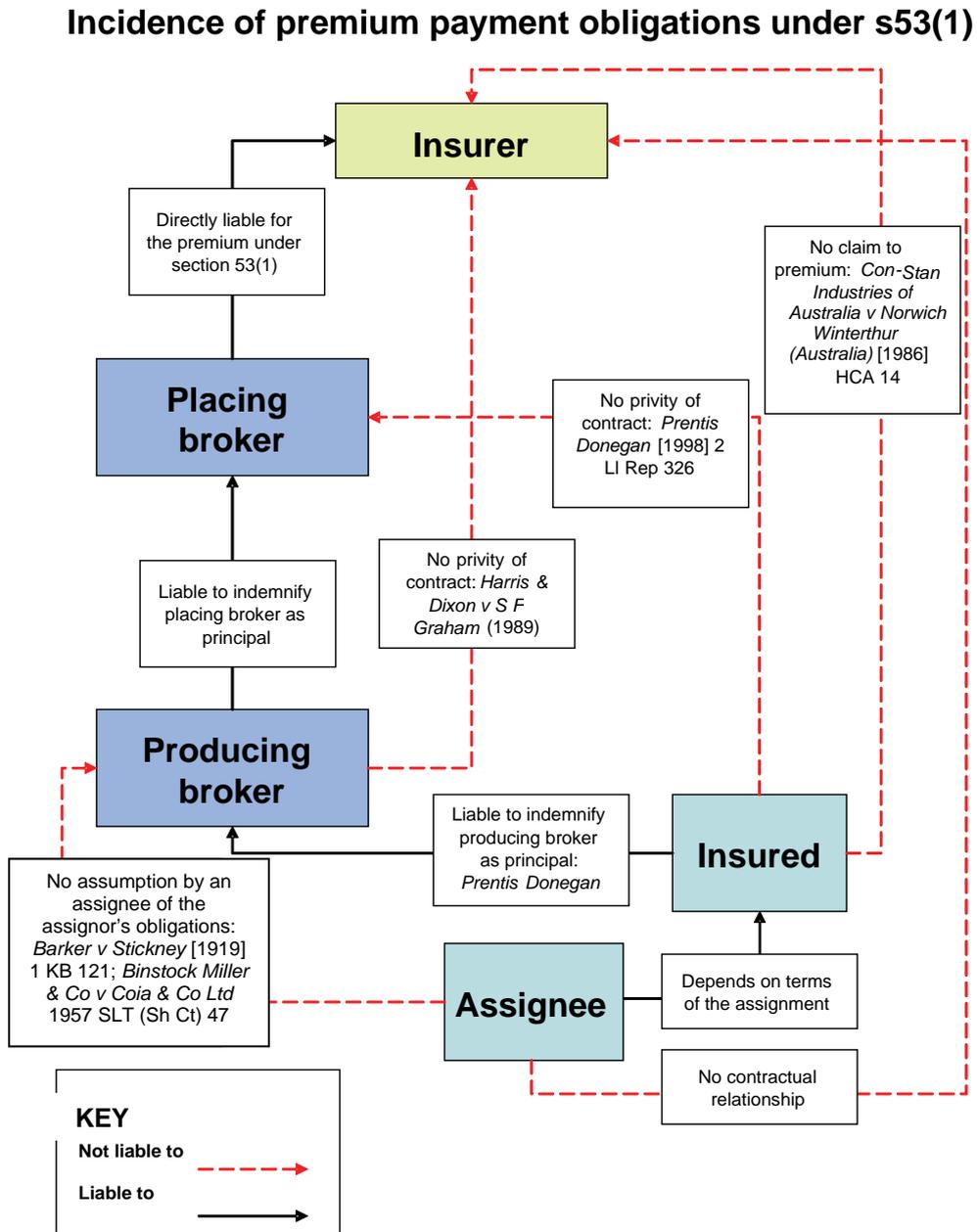
¹⁹ *Con-Stan Industries of Australia Pty Ltd v Norwich Winterthur Insurance (Australia) Ltd* [1986] HCA 14, (1986) 160 CLR 226.

²⁰ Above, at [2].

The chain of brokers

18.37 The effect of the *Universo* case is that the insured is liable to pay the producing broker; the producing broker is liable to pay the placing broker; and the placing broker is liable to pay the insurer. The various links in this chain cannot be missed out.

18.38 The following diagram summarises the law in this area:



The potential problems

18.39 If section 53(1) must be interpreted against its common law background, it has some significant consequences.

- 18.40 Essentially, it means that if a broker becomes insolvent, its liquidators have the right to sue policyholders for any premiums due.²¹ The broker sues on its own behalf: not as agent of the insurer. Thus any money received is held by the broker on behalf of its general creditors, not for the benefit of the insurer. Furthermore, money due from policyholders would not be “client money” within the FSA rules. The insurer would be unable to bypass this process by suing the policyholder in its own name, as it has no recourse against the policyholder.
- 18.41 A likely outcome is that the policyholder would be required to pay the premium to the broker, but the premium would not be passed to the insurer. In these circumstances, it is difficult to say whether the insurer could exercise a premium default clause against an insured to cancel the policy. The issue has the potential to generate litigation, and the outcome is by no means certain.
- 18.42 In its response to us, the IUA explained that in marine insurance, “often a claim is made by the insured prior to the receipt of premium”. Under section 53(1), an insurer is directly responsible to the policyholder for the claim. Where the broker is insolvent, we do not think the insurer would be entitled to deduct any unpaid premium from the claim payment. This is because, under *Universo*, the policyholder is not responsible to the insurer for premium. This effect may not be fully appreciated in the industry.
- 18.43 Below we consider these issues, looking first at the effect of broker insolvency where section 53(1) does not apply. We then contrast this with the possible outcome in marine insurance.

Non-marine insurance: the protections against broker insolvency

Terms of business agreements

- 18.44 In non-marine insurance, where section 53(1) does not apply, it is common for brokers and insurers to agree the effect of a broker’s insolvency in their TOBAs. A TOBA may either transfer the risk of the broker’s insolvency to the insurer (risk-transfer TOBA) or leave it with the insured (non-risk transfer TOBA).
- (1) Under a ***risk transfer TOBA***, the broker receives payment from the policyholder as the agent for the insurer. From the policyholder’s perspective, paying the broker is therefore equivalent to paying the insurer directly. Thus once the premium has been paid, the risk of the broker becoming insolvent falls on the insurer. The insurer is bound to provide cover for the policyholder whether or not it has received the premium.²²

²¹ *J A Chapman & Co Ltd v Kadirga Denizcilik Ve Ticaret* [1998] Lloyd’s Rep IR 377, [1998] CLC 860.

²² The TOBA is an agreement which governs the conduct of business between a broker and an insurer. The broker may also have a Terms of Business Agreement in place with the insured, they are separate agreements. It is a requirement under the Client Assets Sourcebook Rules (CASS 5.2.3 R), that if the broker is holding money as the agent of the insurer it must inform its clients of this. The broker should also inform clients whether this includes all items of client money or whether it is restricted (for example) to the receipt of premiums.

- (2) Under a ***non-risk transfer TOBA***, the broker holds the premium as the agent of the policyholder. Merely paying the premium to the broker is not enough to discharge the policyholder's payment obligations under the policy. Actual payment to the insurer is required.
- 18.45 When the policyholder pays the premium to the broker under a risk transfer TOBA, the broker is responsible to the insurer for any premium it has actually received. It therefore has some limited similarity to section 53(1), but only to the extent that the premium has been paid.

The client money rules

- 18.46 The FSA rules provides special protection to policyholders who pay money to a broker as their agent. These are set out in Client Assets Sourcebook 5, known as "CASS 5".
- 18.47 These rules do not automatically apply to marine business. Marine business covers "large risks", and brokerage activity involving a large risk not situated in the UK is not "insurance mediation activity" within CASS 5.1.1(1).²³ Brokers, however, may elect to extend the CASS rules to large risks. We understand that brokers often extend the CASS rules in this way. Our concern, however, is that if section 53(1) is interpreted against its common law background, it may be incompatible with the CASS rules.
- 18.48 We discuss the CASS rules in Issues Paper 8.²⁴ The rules are complicated, as the recent decision of the Court of Appeal in *Lehman Brothers v CRC Holdings* shows.²⁵ Where a policyholder pays the broker as its agent, however, the overall intention of the rules is relatively simple.

²³ By virtue of articles 3(1), 25(1) and 72D of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.

²⁴ Insurance Contract Law Issues Paper 8: The Broker's Liability for Premiums: Should Section 53 be Reformed? (July 2010), at paras 5.13 to 5.17.

²⁵ [2010] EWCA Civ 917. The *Lehman Brothers* case was concerned with CASS 7 rather than CASS 5, but there are many similarities between the two, including concepts such as "primary pooling event" and "client money account".

- 18.49 Under the CASS rules, client money paid to the broker by the policyholder must be held in a segregated bank account, on trust for the client.²⁶ Where a firm (for example a broker) becomes insolvent, the client money held in each client money account of the firm is pooled.²⁷ It must be paid back to clients, in accordance with their respective interests in it.²⁸ If the money in the client accounts is insufficient, clients take a proportionate share. The rights of policyholders come first. Brokers may also hold money in their client money accounts on behalf of insurers. Insurers also have a claim against money held in client money accounts, but only once the claims of policyholders have been met.²⁹

CASS 5 and section 53(1): is the premium “client money”?

- 18.50 Client money is defined as “any money held on behalf of the client”. It is clear that in the non-marine market, where a policyholder pays premium to a broker, the premium is client money within this definition. The policyholder does not pay the broker directly: instead the policyholder pays the broker as agent, on the basis that the broker will pass the premium on to the insurer. The insured’s liability is to the insurer, not the broker. Thus the broker does not receive the money in its own right, but as agent. Under a risk transfer TOBA the premium is held as agent for the insurer; under a non-risk transfer TOBA, it is held as agent for the policyholder.
- 18.51 Under section 53(1), however, the position changes. The *Universo* case establishes that the insured is not liable to the insurer but only to the broker. The broker has a direct claim against the policyholder: the policyholder pays the broker not as an agent but as a principal. The broker is entitled to retain the money for its own purposes, and has a completely separate debt to the insurer. On this basis, it could be argued that the premium is not “client money”.³⁰ As the premium paid by the policyholder belongs to the broker, the CASS rules do not apply and the broker is entitled to pay it into its own account as soon as it is received.
- 18.52 Even if the marine broker were to treat the premium as client money, and pay it into a client account, it may not be required to repay the money to the policyholder on insolvency. This is because CASS 5.5.67(4) allows the broker to deduct:

²⁶ The CASS rules on statutory trusts (5.3) make a distinction between Scotland and England & Wales and provide for clients’ money to be held solely as agent in Scotland rather than on trust. We do not know the reason for this difference. For example, in the context of a Scottish solicitor holding clients’ funds, it is likely that, as opposed to an agency relationship, the money is held in trust by the solicitor. See Scottish Law Commission Discussion Paper on *Supplementary and Miscellaneous Issues Relating to Trust Law*, Discussion Paper No 148 at para 5.10. As this difference appears to be a defect in the rules, the Scottish Law Commission have drawn it to the attention of the appropriate Government Department.

²⁷ CASS 5.6.7(1)R.

²⁸ CASS 5.3.2(2)R.

²⁹ CASS 5.3.2(3)R.

³⁰ CASS 5.1.5(1)(a)R.

the amount paid to insurance undertakings for the benefit of the client (to include all premiums and commission due to itself) (i.e. commissions that are due but have not yet been removed from the client account).

- 18.53 Thus, on insolvency, the broker can deduct all premiums “due to itself”. As we have seen, where section 53(1) applies, the broker has a claim against the policyholder for the full amount of the premium as soon as it becomes due – whether or not it has paid the premium to the insurer. Therefore, from the broker’s point of view, the premium is “due to itself”.

Broker insolvency: a comparison between marine and non-marine insurance

- 18.54 Now that we have explained the effect of TOBAs and the CASS rules, we can compare the effect of broker insolvency where section 53(1) does not apply, with cases where it does.

- 18.55 Under a non-risk transfer TOBA in non-marine insurance, the insurer does not carry any risk of the broker’s insolvency. Where the policyholder has already paid the premium, the CASS rules require that it must be held on trust for the policyholder in a client money account.³¹ On the broker’s insolvency, the policyholder has a right to its return. Whether or not the policyholder receives the money back, the insurer may bring an action against the policyholder for the premium. The insurer may also deduct any unpaid premium from the claim.

- 18.56 Under a risk transfer TOBA in non-marine insurance, where the policyholder has paid the premium to the broker, then (as far as the policyholder is concerned) the insurer is considered to have received it. The insurer must honour the insurance policy, whether or not it ever receives the premium. Thus, the insurer takes the risk of the broker’s insolvency.

- 18.57 That risk is, however, limited in two ways. First, where the broker holds the premium as the insurer’s agent most TOBAs require that the money is held on trust for the insurer. It is true that where the premium is held in a client money account, the CASS rules require that the insurer’s interests are ranked behind those of policyholders:³² if there is a shortfall in the client accounts, the insurer may never be paid. If the money is there, however, the insurer has a claim to it which ranks ahead of the claims of general creditors.

- 18.58 By contrast, under section 53(1), the broker does not hold the money as an agent for the insurer, but as a principal. It then has a separate, personal obligation to the insurer. The money paid by the insured will belong to the broker’s general creditors, rather than being held on trust for the insurer.

³¹ See footnote 26 which refers to the fact that, in Scotland, for an unknown reason, the CASS rules (CASS 5.3) provide that the broker holds clients’ money as agent rather than on trust.

³² See CASS 5.1.5A

- 18.59 Secondly, under a risk transfer TOBA in non-marine insurance, the risk only applies to premium which has actually been paid. Where a policyholder has not paid the premium, it will normally cancel its agency with the broker, and pay the insurer directly. If the policyholder does not pay, the insurer may sue the policyholder for the premium.
- 18.60 By contrast, under section 53(1), the broker continues to have a claim against the policyholder. This suggests that its liquidators may sue the policyholder and, once the policyholder pays, the money becomes the property of the broker's general creditors. The insurer may not claim the premium directly from the policyholder.
- 18.61 Thus the risk that an insurer bears in marine insurance may be much greater than in non-marine insurance – greater than the industry has fully realised. That said, the issue is fraught with uncertainty. It is possible that a court would not apply the *Universo* decision at all,³³ on the ground that it has been superseded by more recent developments. The issue is likely to generate considerable litigation, with uncertain results.

May the insurer invoke a cancellation clause?

- 18.62 Before concluding the discussion of the effects of section 53(1) on a broker's insolvency, there are two other issues we need to raise. The first is whether the insurer may invoke a cancellation clause. For these purposes, we assume that the policyholder has paid the premium, but the money has been put to the benefit of the broker's general creditors. The insurer has not received it. May the insurer invoke a cancellation clause in the insurance contract to cancel the insurance for non-payment?
- 18.63 The answer must, of course, depend on how the clause is drafted. But even if the clause is drafted in such a way that appears to cover the situation, it is possible that the courts may not allow the insurer to invoke it. This is because of the "common law fiction" underlying the *Universo* decision, namely that the broker has already paid the underwriter, and that the underwriter has lent the premium to the broker.
- 18.64 In Issues Paper 8, we considered how far the "fiction of lending" undermined an automatic termination clause in the contract. There is a High Court decision from 1998 which suggests that it does. In *Prentis Donegan & Partners Ltd v Leeds & Leeds Co Inc*,³⁴ Mr Justice Rix³⁵ held that:

The automatic termination clause cannot operate under English law to forfeit the policy, for the assured's obligations in respect of the premium will always have been timeously discharged.³⁶

³³ *Universo Insurance Co of Milan v Merchants Marine Insurance Co Ltd* [1897] 2 QB 93.

³⁴ [1998] 2 Lloyd's Rep 326.

³⁵ Now Rix LJ of the Court of Appeal.

³⁶ *Prentis Donegan & Partners Ltd v Leeds & Leeds Co Inc* [1998] 2 Lloyd's Rep 326, at 335.

- 18.65 He relied on the “fiction of lending”, as set out in *Universo*,³⁷ to reach the conclusion that the policyholder was always treated as if it had paid the premium to the insurer. As a consequence, even an express termination provision based on late or non-payment of the premium could never take effect under English law. Lord Justice Rix later expressed the same view in a Court of Appeal case, *Charman v New Cap Reinsurance Corp Ltd*, albeit in a non-binding part of his judgment.³⁸
- 18.66 *Prentis Donegan*³⁹ is probably no longer good law. Professor Merkin comments that it cannot stand in the light of comments in two subsequent Court of Appeal cases.⁴⁰
- 18.67 Furthermore, in 2008, the Commercial Court explicitly rejected the idea that the fiction continues to apply. In *Allianz Insurance Co Egypt v Aigaion Insurance Co SA*,⁴¹ the policyholder argued that a payment warranty in marine insurance was always ineffective because the common law fiction underlying section 53(1) meant that the policyholder was always deemed to have paid the premium to the insurer. The court rejected this argument. It held that the fiction had been superseded by the 1906 Act. Since 1906, the fiction was no longer needed as the statute produced the necessary result.
- 18.68 In Issues Paper 8, we concluded that it was unlikely that the fiction would be used to undermine the validity of a premium payment warranty. On the other hand, the issue was not beyond all doubt. Although *Allianz* firmly states that premium payment warranties should not be rendered ineffective by the common law fiction, the fact that the warranty was not incorporated into the policy in that case means that the statement is strictly non-binding. Uncertainty remains.
- 18.69 It is possible that the courts may revive the fiction of lending if they considered it was necessary to do justice in the case. In his response to us, Lord Justice Longmore thought that the fiction of lending may be useful if it became necessary to protect policyholders. He commented:
- If the broker becomes insolvent, the insurer may be unable to recover his premiums. But... what is wrong with that? It is the broker with whom he does business and the broker whom he has wrongly trusted.
- 18.70 Lord Justice Longmore then commented that the policyholder should not be prejudiced by having to pay a second time. He continued:

³⁷ [1897] 2 QB 93.

³⁸ [2003] EWCA Civ 1372, [2004] Lloyd's Rep IR 373, at [10].

³⁹ *Prentis Donegan & Partners Ltd v Leeds & Leeds Co Inc* [1998] 2 Lloyd's Rep 326.

⁴⁰ R Merkin (ed), *Colinvaux & Merkin's Insurance Contract Law*, at para B-0380. He cites *J A Chapman & Co Ltd v Kadirga Denizcilik Ve Ticaret* [1998] Lloyd's Rep IR 377; and *Heath Lambert Ltd v Sociedad de Corretaje de Seguros* [2004] EWCA Civ 792, [2004] 1 WLR 2820. Both cases are discussed in Issues Paper 8, Part 3.

⁴¹ [2008] EWHC 1127 (Comm), [2008] 2 Lloyd's Rep 595.

That is not the only prejudice the policyholder may suffer. If the insurer's liability is subject to a condition precedent that the premium has been paid, the policyholder will not be able to recover. That is why the policyholder needs the "fiction" that the premium has been paid. If the "fiction" is abolished, there is a danger that the policyholder will be denied recovery even if he has paid the premium to the broker.

- 18.71 We therefore cannot say whether an insurer would be entitled to cancel a marine policy against a policyholder who had paid a premium to a broker but the premium had not reached the insurer. The law is uncertain.

Contracting out of section 53(1)

- 18.72 The final issue is how far the parties may contract out of section 53(1). Section 53(1) clearly states that it only applies "unless otherwise agreed". Thus if the parties wish to avoid the possible consequences outlined above, it is open to them to contract out of the effects of the section.

- 18.73 On the other hand, contracting out of section 53(1) is not easy. The section has three possible consequences, and the consequences affect three parties. The contract would need to be between the right parties. In other words:

- (1) The broker is directly liable to the insurer for the premium: to contract out of this, a contract between the broker and the insurer is needed.
- (2) The insured is directly liable to the broker for the premium: to contract out, a contract between the insured and the broker is needed.
- (3) The insured is not liable to pay premium to the insurer: to contract out, a contract between the insured and the insurer is needed.

- 18.74 Thus to contract out of the full effects of section 53(1), either three separate contracts, or one contract with three parties is needed. If only two parties contract out of the clause, problems emerge. For example, if broker and insurer agree that the broker is not directly responsible for the premium, the insurer could find that it has no claim for the premium at all, against either broker or insured.

- 18.75 Furthermore, it appears that to contract out of section 53(1), a clearly worded clause is required. In *Universo*,⁴² the reinsurer argued that it was entitled to claim premium from the policyholder. One reason it put forward was that the policy included an express promise by the policyholder to pay the premium. The Court of Appeal held that "the promise by the assured to pay the premium may be read as a promise to pay in the customary manner, namely, by the broker".⁴³ As a result, the custom applied and the reinsurer could not recover the premium from the policyholder directly.

- 18.76 We think that it is too easy for the parties to fall into section 53(1) without realising the full consequences – and too difficult to exclude it.

⁴² *Universo Insurance Co of Milan v Merchants Marine Insurance Co Ltd* [1897] 2 QB 93; and see para 118.29 above.

⁴³ Above, by Chitty LJ at p 101.

CONCLUSION

- 18.77 Section 53(1) is fraught with risk, complexity and uncertainty. It does much more than simply make the broker liable to pay the premium. Instead it is part of a complete system for premium payment, based on nineteenth-century practice, in which policyholders are not liable to pay insurers. Instead, policyholders are only liable to brokers, who receive the money in their own right, rather than as agents for either party. This has the potential to undermine FSA rules on client money and leaves both insurer and policyholder exposed to unexpected risks on the broker's insolvency.
- 18.78 We conclude that the section needs to be reformed. In Part 19 we discuss possible replacements.

PART 19

THE BROKER'S LIABILITY FOR PREMIUM: PROPOSALS FOR REFORM

- 19.1 As we have seen, section 53(1) is a complex and difficult provision. It appears to embody the common law rule that the insured is not liable to pay premium to the insurer.¹ Instead, the insured is liable to pay the broker, who receives the money in its own name and has a separate debt to the insurer.
- 19.2 When the parties are solvent, there is little difference between paying money to an insurer through a broker and paying money to a broker, who then has a separate debt to the insurer. Both appear to be the same practice: the broker collects and passes on premiums. When one party is insolvent, however, the results differ markedly.
- 19.3 It is known and understood that, under section 53(1), when the policyholder becomes insolvent the broker remains liable to the insurer.
- 19.4 There is less appreciation of the effect of section 53(1) where the broker becomes insolvent. The issue becomes extremely uncertain. It would appear that an insured does not pay the broker as agent but as principal. Thus the premium paid to the broker is not "client money" held on trust for the insured or insurer.² Instead, it is paid to the broker beneficially (that is to say, outright), and belongs to the broker's general creditors. If the policyholder has not already paid the premium, the broker's liquidator may sue the policyholder for the debt on behalf of the creditors as a whole. This is an unsatisfactory result.

RESPONSES TO ISSUES PAPER 8

- 19.5 In Issues Paper 8, we argued that the section should be reformed. We tentatively proposed to remove marine brokers' automatic liability for the premium. Instead, we suggested that brokers should only be liable to pay premiums if they specifically agreed to take on such a responsibility.
- 19.6 We received 18 responses. There was a consensus that the section needed to be reformed and clarified. There was less consensus however, over whether brokers should be automatically liable to pay premiums.

The need to clarify the section

- 19.7 In Issues Paper 8, we observed that section 53(1) codified a common law fiction whereby the broker is always deemed to have paid the premium to the insurer and the insurer to have lent the money back to the broker. We said that this has produced unprincipled and conflicting case law, particularly in the context of premium payment warranties and additional premium payments.

¹ Set out in *Universo Insurance Co of Milan v Merchants Marine Insurance Co Ltd* [1897] 2 QB 93 at p 99.

² For the position in Scots law, see Part 18, fn 26.

- 19.8 All 14 consultees who expressed a view on this point agreed. Munich Re said this caused “analytical difficulties with the use” of payment protection warranties and cancellation clauses that needed to be eliminated.
- 19.9 We went on to observe that, at present, attempting to contract out of section 53(1) may prove difficult. Of the 13 consultees who expressed a view, 12 agreed. Consultees indicated there were two problems. One was the requirement for “clear wording” to displace section 53(1). The other was that a Terms of Business Agreement (TOBA) might need to be a tripartite agreement in order for the insured to be bound by it or to take the benefit of it. Most consultees thought that the parties should have an unfettered right to agree whatever arrangements they saw fit.
- 19.10 Mixed views were expressed over whether section 53(1) posed a risk to insurers on a broker’s insolvency. Four consultees felt that it did. The Financial Services Authority (FSA), however, thought that the Client Assets Sourcebook (CASS) rules provided adequate protection.

Automatic liability: the case against automatic liability

- 19.11 The most controversial issue was whether brokers should be liable to pay insurers when the policyholder becomes insolvent. Of the 15 consultees who gave us their views, nine (60%) said that there was no justification to make brokers responsible for paying premiums in most cases. As the General Council of the Bar put it, insurers “ought to be able to look after themselves”. The City of London Law Society observed that an insurer can now carry out checks on the creditworthiness of an insured online.
- 19.12 Marsh and Guy Carpenter described section 53(1) as a major concern for brokers. Harbour Insurance Brokers Ltd considered that justifications for imposing personal liability on a broker were “few and far between”, and should only apply in specific circumstances, as agreed between the parties. The Institute of Insurance Brokers supported the current market practice whereby brokers were responsible for collecting and passing over premiums. On the other hand, they commented that:

Members have expressed the view that there should be some concession in relation to a policyholder who becomes insolvent with premiums outstanding, so that the broker is not obliged to bear the credit risk alone.

- 19.13 Interestingly, one insurer, Munich Re, agreed that section 53(1) should be repealed:

The repeal of section 53(1), including an express repeal of the common law fiction which predated it, would therefore be a very welcome development in the law. We see no difficulties with the proposed default rule that brokers should not be automatically responsible for the premium unless the contract provides otherwise.

The case in favour of automatic liability

19.14 On the other hand, three major insurer organisations, the Lloyd's Market Association (LMA), International Underwriters' Association (IUA) and Association of British Insurers (ABI), argued in favour of preserving automatic liability on brokers. They gave two main reasons. First, in practice, the broker has contact with the policyholder and is responsible for collecting premiums. The LMA commented that it was the broker's responsibility to collect the premium, noting that it was especially difficult for an insurer to enforce the insured's payment obligation where there was a chain of brokers. Brokers may do this with more vigour if they stood to lose the whole premium rather than just their commission.

19.15 Secondly, broker liability was a useful additional protection in short-term insurance where they were unable to exercise cancellation clauses. The IUA indicated that this was especially important in marine insurance:

Marine risks are commonly written on a bespoke, short term basis - thus with limited scope for long-standing business arrangements with the insured. In such cases - often high risk, large premium business - there is increased reliance on the broker in bringing the business to the insurer. Premium is rarely received up front and it would be impracticable in such circumstances, and contrary to general practice, for the underwriter to request it.

19.16 The ABI stated that section 53 was "fundamental to marine business". It argued that:

Marine insurance is different...The high insured limits and mobility of assets insured, compounded by the unfamiliarity between insurer and policyholder, are specific concerns of the marine insurance market and would unduly expose the insurer if the broker were not made personally liable for the premium.

19.17 The British Insurance Law Association (BILA) acknowledged that some aspects of marine business made it difficult for the insurer to assess the insured's credit risk, especially for "one-ship companies incorporated in locations such as Monrovia or Panama". Nonetheless, BILA thought that on balance, the risk ought to be borne by the insurer; the contract was ultimately an agreement between the insurer and the insured.

OUR PROPOSALS

19.18 In brief we propose that:

- (1) Section 53(1) should be re-enacted in a way that does not preserve the common law underpinnings. The policyholder should be liable to pay premium to the insurer, and should pay the broker as agent. Any liability assumed by the broker should be in addition to the policyholder's liability, not a substitute.
- (2) The issue of whether the broker is liable to pay the premium to the insurer should be a matter of agreement between broker and insurer.

- (3) We consider what the default rule should be: should brokers be liable for paying premiums unless they contract out of liability, or only if they contract in? On balance, we suggest that marine brokers should be responsible unless they contract out.

The policyholder should be liable to the insurer for premiums

- 19.19 We think that the normal rules which apply in non-marine insurance should also apply in marine insurance. The policyholder should be primarily liable to the insurer, and should pay the broker as agent. The payment should be “client money”, held on trust according to the terms of the broker’s TOBA.
- 19.20 This raises the question of whether premiums received by a broker should be held on trust for the insurer or for the policyholder. We intend to follow the current practice, as it applies in non-marine insurance. The normal arrangement is that a broker receives premiums as the policyholder’s agent. This means that, under the CASS rules, the broker holds the money on trust for the policyholder until it is passed to the insurer (“non-risk transfer TOBA”).³ However, the broker and insurer may agree that the broker receives the premium as agent for the insurer. This means that the policyholder is deemed to have paid the insurer when it pays the broker, (“risk transfer TOBA”). Under the TOBA, the broker normally holds the money on trust for the insurer. We think the same arrangements should also apply here. The general rule is that the broker holds premium as agent for the policyholder, but this is subject to a contract between broker and insurer.
- 19.21 We propose that the broker should have a right to claim payment from the policyholder directly in its own name only once it has paid the insurer. Once the payment has been made, the broker should then acquire any rights the insurer had against the policyholder. We return to this issue in Part 20, when we discuss the broker’s lien. In Part 20, we propose that the broker should not only have the right to sue for the debt, but should also have a statutory right to set off the money it is owed from any proceeds it holds on the policyholder’s behalf.
- 19.22 **Do consultees agree that where marine insurance is effected on behalf of an insured by a broker:**
- (1) the policyholder should be liable to pay the insurer?**
 - (2) when the broker collects the premium, policyholders should pay the broker as an agent?**

³ The CASS rules on statutory trusts (5.3) make a distinction between Scotland and England & Wales and provide for clients’ money to be held solely as agent in Scotland rather than on trust. We do not know the reason for this difference. For example, in the context of a Scottish solicitor holding clients’ funds, it is likely that, as opposed to an agency relationship, the money is held in trust by the solicitor. See Scottish Law Commission Discussion Paper on *Supplementary and Miscellaneous Issues Relating to Trust Law*, Discussion Paper No 148 at para 5.10. As this difference appears to be a defect in the rules, the Scottish Law Commission have drawn it to the attention of the appropriate Government Department.

(3) as a general rule, the broker should hold premium as agent for the policyholder, but this should be subject to a contract between broker and insurer?

(4) the broker's liability to pay premiums to the insurer should be a matter of agreement between broker and insurer?

The broker's liability to the insurer: a matter of agreement

19.23 Almost all those responding to Issues Paper 8 agreed that the parties to the contract between the insurer and the broker should be entitled to decide on the broker's responsibility for paying premiums to the insurer. It should be relatively easy to include a term on the issue in the TOBA between broker and insurer. It should not require a three-party agreement with the insured, as the policyholder's obligations would remain unaffected.

19.24 Where the broker assumes liability for paying the premium, this should not replace the policyholder's liability to pay. Instead, the broker would become jointly and severally liable for the debt.

A default rule that marine brokers are responsible for premium?

19.25 The controversial issue was the default rule. Should a marine broker be responsible for the premium, unless the parties contracted out of responsibility? Or should the broker only be responsible if it specifically contracts with the insurer to this effect?

19.26 The main insurer organisations argued in favour of a default rule that marine brokers should be responsible for paying premium, unless there was an agreement to contract out of responsibility. The argument for such a default rule was that it was already market practice. Given the nature of marine insurance, such responsibility was necessary to make the market work smoothly. As brokers and insurers would usually wish to agree such responsibility, it was simpler to make this the default rule.

19.27 By contrast, other respondents argued that the rules for marine and non-marine insurance should be the same: brokers should only be responsible for others' debts if they specifically agreed to take such responsibility. Guaranteeing the debt of another was a serious undertaking, and brokers should only do so consciously, and with thought.

19.28 There are strong arguments in both directions. On balance however, we provisionally propose that the default rule should mirror the current law: brokers should be jointly and severally liable with the insured for paying premium. We say this because a default rule to this effect most closely resembles current market practice and would cause minimum disruption to the way the parties currently do business. It should be easy however, for brokers to contract out of this responsibility through a term in their TOBA with the insurer.

- 19.29 If this default rule were to be enacted, it would be helpful to clarify that it applies equally to adjusted premiums. As the rule is part of the relationship between broker and insurer, it would apply whenever the broker/insurer relationship is governed by English or Scots law, irrespective of the law under which the insurance contract is written.
- 19.30 We would however, be interested to hear arguments in favour of the opposite default rule: that is, that brokers should not be responsible for paying premium unless the parties agree otherwise.
- 19.31 **Do consultees agree that where a marine insurance contract is effected on behalf of a policyholder by a broker:**
- (1) the default rule should be that the broker is jointly and severally liable with the insured to pay the premium to the insurer?**
 - (2) the broker and insurer should be able to contract out of this provision?**
 - (3) the default rule should apply equally to initial and adjusted premiums?**
 - (4) the default rule should apply whenever the broker/insurer relationship is governed by English or Scots law, irrespective of the law under which the insurance contract is written?**

PART 20

THE BROKER'S LIEN AND OTHER PROVISIONS

- 20.1 In this Part we consider two further provisions of the Marine Insurance Act 1906. These are the broker's lien under section 53(2) and the effect of an acknowledgement under section 54. We start by explaining section 53(2) and the uncertainties it gives rise to. We then consider the case for reforming section 53(2). Finally, we explain why we think section 54 should be repealed.

THE BROKER'S LIEN UNDER SECTION 53(2)

What is a lien?

- 20.2 A lien is a traditional form of security which operates where debtor A's property is lawfully in creditor B's possession. A lien permits B to retain the property until A has paid the debt. Liens may either be general or specific. A general lien extends to any debt (within the relationship between the parties involved) which A owes. A specific lien¹ extends only to debts which relate to the contract under which B holds the property.
- 20.3 The courts will imply a specific lien in most agency situations, but agents do not have a general lien unless there is an established custom to that effect.² The courts have recognised general liens in favour of bankers,³ stockbrokers,⁴ and solicitors.⁵ At common law in both England and Scotland, a marine insurance broker also enjoyed a general lien unless, to its knowledge, it was dealing with an agent of the insured.⁶

Section 53(2)

- 20.4 The common law position was codified in section 53(2) of the 1906 Act, which provides:

¹ In Scots law, specific liens are known as special liens. See A J M Steven, *Pledge and Lien* (2008), para 9-01.

² In Scotland, agents have a general lien. See A J M Steven, *Pledge and Lien* (2008) at para 17-53.

³ *Brandao v Barnett* (1846) 12 Cl & Fin 787.

⁴ *Jones v Peppercorne* (1858) 131 ER 430 at p 445; *Glendinning v John D Hope & Co* 1911 SC (HL) 73. For Scots law, see A J M Steven, *Pledge and Lien* (2008), paras 17-11 and 17-12.

⁵ *Wilkins v Carmichael* (1779) 1 Doug KB 101 at p 104.

⁶ *Maspous y Hermano v Mildred, Goyeneche & Co* (1882) 9 QBD 530 at p 543. For Scots law see Bell, *Commentaries* II, 115 and A J M Steven, *Pledge and Lien* (2008) at paras 17-39 to 17-47.

Unless otherwise agreed, the broker has, as against the assured, a lien upon the policy for the amount of the premium and his charges in respect of effecting the policy; and, where he has dealt with the person who employs him as a principal, he has also a lien on the policy in respect of any balance on any insurance account which may be due to him from such person, unless when the debt was incurred he had reason to believe that such person was only an agent.

- 20.5 Section 53(2) contemplates two different types of lien.
- 20.6 First, where a broker deals with another agent, it has a specific lien, unless it had no reason to believe that it was dealing with an agent.⁷ The lien can only be asserted in relation to unpaid premiums and charges due under the particular policy.⁸ Thus a placing broker cannot retain funds due to one insured because the producing broker has failed to pay a premium in respect of a different insured.
- 20.7 Second, where a broker deals directly with the assured, it has a general lien which can be exercised for any deficit on the insured's insurance account as a whole.
- 20.8 At one stage there was doubt whether the lien only applied to the policy document, or whether it also gave brokers the right to retain any proceeds in their possession in satisfaction of debts owed to the broker.⁹ In 1999, in *Eide UK Ltd v Lowndes Lambert Group Ltd*, the Court of Appeal resolved this issue in favour of brokers. As Lord Justice Phillips said:¹⁰

A broker who has a lien over a policy of marine insurance is normally entitled, when he collects under the policy, to apply the proceeds collected in discharge of the debt that was protected by the lien.¹¹

- 20.9 The decision breathed new life into section 53(2), suggesting that it was still a practical tool available to brokers. Where it applies, brokers effectively have a right to set off any debt owed to them against the policy proceeds in their possession.

⁷ There is a presumption that a broker believes his immediate employer to be the principal: *Westwood v Bell* (1815) 4 Camp 349 at p 353.

⁸ *Maspous y Hermano v Mildred, Goyeneche & Co* (1883) 8 App Cas 874.

⁹ *Fairfield Shipbuilding and Engineering Co Ltd v Gardner, Mountain and Co Ltd* (1911) 104 LT 288. In Scots law, it would appear that, when sums under the policy are paid out by the underwriter to the broker, the lien transforms into a right of retention in respect of that sum. See A J M Steven, *Pledge and Lien* (2008), para 17-45.

¹⁰ Now Lord Phillips of Worth Matravers, President of the UK Supreme Court.

¹¹ *Eide UK Ltd v Lowndes Lambert Group Ltd (The Sun Tender)* [1999] QB 199, at p 211.

20.10 In Issues Paper 8, we said it was not clear whether section 53(2) was confined to marine insurance or whether it also applied to non-marine insurance. It is possible that in England and Wales non-marine brokers have a specific lien only,¹² providing more limited protection.

Third party interests

20.11 A general lien can operate unfairly against third parties with an interest in the proceeds or the premium.

20.12 This is illustrated by the facts in *Eide*.¹³ The operators of a fleet of ships mortgaged one of their vessels to a bank. They used a broker to extend their insurance to the vessel on behalf of themselves, the owners and the bank. All three parties were co-insured under the contract. When a claim was made, the broker attempted to retain all the claims proceeds to pay the operators' outstanding liabilities under an unrelated insurance account. This would have deprived the bank and the owners of substantial sums.

20.13 The Court of Appeal found that the general lien did not apply to composite insurance. In these circumstances, the broker did not "deal with the person who employs him as a principal" as required by the words of section 53(2). The phrase did not apply where a party placed insurance on its own behalf and on behalf of other interests. Nor was it possible for a party to create a lien beyond its own interest.

20.14 In its response to us, Marsh and Guy Carpenter observed that the statutory lien rarely gives brokers adequate protection where third parties such as mortgagees have an interest in proceeds. On the other hand, there are good policy reasons for protecting innocent third parties from loss where a co-insured has failed to pay premiums on some unrelated contract.

Does the right to proceeds depend on possession of a policy?

20.15 In Issues Paper 8, we concluded that the broker's lien operated satisfactorily in marine insurance.¹⁴ In Issues Paper 9, however, we examined this issue again, as we considered the meaning of a "marine policy" in the 1906 Act.

20.16 At this stage, we identified a potential problem with section 53(2). In *Eide*, Lord Justice Phillips describes the right to collect a debt from proceeds as a "commensurate right" to the lien.¹⁵ He states that it is a fallacy to argue that:

the right of set-off in relation to proceeds is simply a feature of the law of agency and has no connection with the broker's lien on the policy.¹⁶

¹² In Scots law, brokers are recognised as being among the limited categories of persons endowed with a general lien. See A J M Steven, *Pledge and Lien* (2008), paras 17-39 to 17-47.

¹³ [1999] QB 199.

¹⁴ Issues Paper 8, para 6.55.

¹⁵ *Eide UK Ltd v Lowndes Lambert Group Ltd (The Sun Tender)* [1999] QB 199, at 211.

¹⁶ [1999] QB 199 at 210.

- 20.17 It appears from Lord Justice Phillips' reasoning that the right of set off is dependent on the lien.¹⁷ This would mean that it only arises where the broker has physical possession of the marine policy.
- 20.18 A further complication is that a lien requires a tangible or, in Scots law, corporeal object – that is, a paper policy rather than an electronic one. In Issues Paper 9, we explained that the English courts have never recognised a lien over an electronic document. It is also unlikely that the Scottish courts would recognise such a lien given that an electronic document does not have a physical presence.¹⁸ We thought that, as electronic commerce continues to develop, the courts might begin to recognise liens over electronic documents, but this would be a significant legal change.¹⁹
- 20.19 This leads to a potential problem: if the broker does not possess a physical policy document, does it have the right to set-off a general debt against any proceeds it holds on behalf of the insured? We are not able to give a clear answer to that question.

THE BROKER'S LIEN: THE CASE FOR REFORM

Our initial proposal

- 20.20 In Issues Paper 9, we thought that there was a need to clarify the law in this area. Under the law as it currently stands, there was doubt whether the lien applied to non-marine insurance as well as marine insurance. There was also doubt over whether a broker who does not possess a physical policy document is entitled to retain proceeds in respect of a debt under another contract.
- 20.21 We tentatively proposed that section 53(2) should be amended or replaced by a new provision. This should apply to both marine and non-marine insurance. It should give the broker a general lien over all property of the insured that has lawfully come into the broker's possession in its capacity as broker. Furthermore, it should give the broker a right to retain any funds held on behalf of the insured to settle the insured's outstanding debts in respect of premiums or charges.

Consultees' views

- 20.22 Most consultees agreed with us. The Lloyd's Market Association (LMA) and Association of British Insurers (ABI) however, both expressed concern that a general right of set off may extend too widely. The LMA was particularly concerned about the situation where an insured had paid a premium to the broker under a risk-transfer agreement, so that the premium was held on behalf of the insurer. It is important that any premium the broker receives on behalf of Insurer A is not retained to discharge a different debt to Insurer B. The ABI suggested it would be preferable to provide only a specific lien, rather than a general one against all money held by the broker.

¹⁷ On the twin rights of lien and set off, see A J M Steven, *Pledge and Lien* (2008) at para 17-27.

¹⁸ Compare *Onyvax Ltd v Endpoint Research (UK) Ltd* [2007] CSOH 211; 2008 GWD 1-3.

¹⁹ Issues Paper 9, paras 4.31 to 4.33.

- 20.23 We accept that a general lien can operate unfairly against third parties with an interest in the proceeds or premium. Any replacement of section 53(2) would need to protect insurers and co-insureds from loss. We would also need to preserve the current rule that where the broker's client was a sub-agent, the right to retain proceeds was confined to the premium or charges in respect of that particular policy.
- 20.24 The General Council of the Bar, LMA and the International Underwriting Association (IUA) also queried whether the broker needed any special protection if brokers were no longer responsible for paying premiums. The IUA for example, pointed out that if the insurer is required to pursue the policyholder for any unpaid premium, it is illogical to allow the broker to operate the lien.
- 20.25 As we explained in Part 19, we are proposing that both marine and non-marine brokers may enter into Terms of Business Agreements (TOBA) which impose a contractual obligation to pay premiums. We think the broker's right to set-off should only apply where the broker had actually paid the premium in accordance with a legal obligation.

Our proposals now

- 20.26 Our proposals apply to both marine and non-marine insurance where a broker has paid a premium to the insurer pursuant to a legal obligation to do so. As we discussed in Part 19, we think that where the broker has paid the premium on behalf of the insured, it should be entitled to exercise any right the insurer has to recover the debt from the policyholder. In particular, it should have a right to sue the policyholder for the debt.
- 20.27 In Part 17 we propose the repeal of the requirement that a marine insurance contract must be embodied in a marine policy. With the end of formal policies, the broker's lien over the policy becomes practically defunct. Therefore section 53(2) ought to be repealed and replaced with a form of security for the broker which does not depend on the existence of a policy document. This cannot be a lien in the technical sense, as a lien requires a tangible or, in Scots law, corporeal object.
- 20.28 Instead, under our proposals, the broker would have a specific statutory right to set off any premium or commission against the proceeds on that policy. Where no third party interests are involved, a broker should have a more general right to set off any money owed by the insured against any money held by the broker on behalf of that insured.
- 20.29 With a general right of set off, it is important to protect the interests of third parties. Clearly, we would not wish to use any premium paid under a risk transfer TOBA to Insurer A to recoup premium paid by the broker to Insurer B. We also intend to follow the current law, by protecting the ultimate insured where the debtor is a producing broker or other sub-broker in the chain. Furthermore, we propose to follow the decision in *Eide* to protect mortgagees and other co-insureds.

- 20.30 Below we ask whether we should go further than this. The current limitation on broker debts only applies where the broker “had reason to believe such a person was only an agent”. We are not sure if this limitation is necessary: should we go further, and restrict the general lien whenever the proceeds are owed to a third party who has no relationship to the debt? We also welcome views on whether it would be desirable to protect third parties in liability claims. For example, would an employee making an employers’ liability claim ever be prejudiced by such a general right of set off?
- 20.31 **Do consultees agree that that section 53(2) should be repealed and replaced by a new provision which applies to both marine and non-marine insurance?**
- 20.32 **Do consultees agree that the statute should provide that where the broker is obliged to pay any premium to the insurer and has done so:**
- (1) the broker should be entitled to exercise the insurer’s rights to recover the debt from the policyholder?**
 - (2) the broker should have a statutory right to set off any premium or commission against the proceeds arising from that policy?**
 - (3) where no third party interests are involved, the broker should have a general right to set off any debt owed to it by the insured against any money held by the broker on behalf of the insured?**
- 20.33 **We welcome views on how third party interests should be defined.**

SECTION 54

- 20.34 The section reads as follows:

Effect of receipt on policy

Where a marine policy effected on behalf of the assured by a broker acknowledges the receipt of the premium, such acknowledgement is, in the absence of fraud, conclusive as between the insurer and the assured, but not as between the insurer and broker.

- 20.35 In Issues Paper 8, we struggled to make sense of this provision. We thought that it was probably designed as a form of protection for a policyholder whose broker fails to pay the premium.²⁰ If the policy acknowledged payment by the policyholder, the insurer would not be able to refuse to pay out a claim on the ground that the policyholder had not paid the premium. The insurer would, however, still be able to claim the premium back from the broker, relying on the broker’s direct liability under section 53(1).
- 20.36 We asked whether the provision had any relevance in modern insurance law. We were not sure that contemporary policies would ever include such an acknowledgement.

²⁰ See R Merkin (ed), *Colinvaux & Merkin’s Insurance Contract Law*, at para B-0361.

- 20.37 We received 13 responses to this question. Only one respondent thought that the section had any relevance. It explained that if an insured had paid only the first instalment, and a claim arose during the period covered, section 54 would prevent the insurer from denying the claim where a subsequent instalment was missed. Two consultees, however, pointed out that in such a situation a clause acknowledging payment could be relied on as an estoppel (or, in Scots law, personal bar) or contractual warranty. There was no need for additional statutory protection.
- 20.38 We do not think that the provision has any purpose in modern insurance law. We propose that it should be repealed.
- 20.39 **Do consultees agree that section 54 should be repealed?**

CHAPTER 5

CONCLUSION

PART 21

ASSESSING THE IMPACT OF REFORM

- 21.1 In this Part, we summarise the main benefits and costs of the proposed reforms, set out in the previous four chapters. Alongside this Consultation Paper we are also publishing a full impact assessment of our proposals,¹ and consultees are referred to the full impact assessment for further details.

DAMAGES FOR LATE PAYMENT

- 21.2 In Chapter 1 we discuss the current English rule that if an insurer promises to pay valid claims and fails to do so within a reasonable time, the insurer is not liable to pay damages for any loss an insured may suffer.
- 21.3 The effects of this rule are particularly acute for small and medium businesses² who are often especially vulnerable following a catastrophic event, such as a fire, flood or riot. However, AIRMIC³ commented that even large businesses may sometimes be vulnerable to unreasonable delay following a catastrophe.
- 21.4 The issue of timely payments has become more acute as firms find it harder to obtain bridging loans from banks in the current economic climate. The BIS Small Business Survey 2010 found that 21% of all SMEs seeking finance did not obtain any of the finance they sought, even though the amounts sought tended to be small.⁴ This represented a significant increase from previous studies.
- 21.5 The importance of prompt payment is illustrated by the difficulties faced by small businesses after a major flood. In 2005, David Crichton summarised research on this issue, looking in particular at the problems following the floods in 2000.⁵ A survey by AXA in 2003 found that the majority of small businesses affected by these floods either never re-opened or ceased trading within 18 months. Insurers who deal with claims fairly and promptly can make a significant difference to restoring economic activity following a flood.
- 21.6 In order to gauge the current scale of late payment of insurance claims, we sought a snapshot of brokers' views. We worked with an independent research panel, Broking Now!,⁶ who asked five questions in their September questionnaire to a representative sample of 250 UK commercial insurance brokers.

¹ Available on our websites at <http://www.lawcom.gov.uk> (see A – Z of projects and follow the link to insurance contract law) and <http://www.scotlawcom.gov.uk> (see news column).

² Employing between 10 and 250 staff.

³ Which represents insurance buyers and risk managers for around three-quarters of FTSE 100 companies.

⁴ Of those seeking finance, 18% had asked for less than £10,000 and 37% had asked for between £10,000 and £49,000 (BIS Small Business Survey 2010 (April 2011)).

⁵ *Flood Risks and Insurance in England and Wales: Are there any lessons to be learned from Scotland?* Benfield Hazard Research Centre (March 2005).

⁶ Broking Now!, Research on Damages for Late Payment (September 2011).

- 21.7 In all, 60% of brokers said they had experience of unreasonable delay.⁷ However, such cases were infrequent: two thirds of all brokers who had experienced delays stated that they occurred in less than 10% of cases, and almost half (47%) stated that they occurred in less than 5% of cases.
- 21.8 Further, when delays did occur, they generally caused only minor losses. In 90% of cases brokers estimated the average financial loss as a result of an insurer's unreasonable delay was no more than £5,000, and in 71% of cases was no more than £2,000.⁸ Substantial losses are extremely rare, but they do sometimes occur. Three brokers mentioned cases with losses of more than £10,000. One broker reported a loss of over £100,000.
- 21.9 This suggests that unreasonable delay is considered a problem within the industry, but only in a small minority of cases. Where delay does occur, it usually results in only minor losses. Substantial losses are rare, but may on occasion lead to serious problems.

Benefits

- 21.10 The proposals are designed to provide incentives for insurers to assess and pay claims quickly. Prompt payment would enable more businesses to survive the effects of catastrophic events such as fires and floods, resuming production and avoiding business failure.
- 21.11 Business failure is regrettably common. The ONS Statistical Bulletin on business demography for 2009⁹ shows that 279,000 businesses ceased trading, a 26% increase from the previous year. This compares with only 236,000 business births. Business failure not only affects owners and shareholders, but also causes loss to employees, creditors, tax authorities, the community and the general economy.
- 21.12 We cannot say how many businesses would be able to continue as a result of our proposals, but would have failed had the law been left unchanged. Even if only a few businesses were able to continue, the results could be significant. The BIS Small Business Survey 2010 showed that the average turnover for a small business with between 10 and 49 staff was £2.84 million. This means that if two small businesses were saved by prompt payment, it would preserve more than £5 million in economic activity which would otherwise be lost.
- 21.13 **What are the likely benefits if prompt payment prevents businesses from ceasing to trade? We invite comments on the view that such benefits may exceed £5 million.**

Costs

- 21.14 The reforms will not affect consumers and very small businesses, where the FOS already has jurisdiction to provide compensation. Nor will it have any effect on

⁷ By contrast, 36% said they had no experience of unreasonable delay in settlement, and 4% did not know.

⁸ In all 65 brokers provided a figure.

⁹ Published in December 2010.

liability insurance claims, where late payment is rarely an issue for the insured. The problem is largely confined to property and contents insurance.

- 21.15 ABI statistics show that in 2010, UK insurers paid £1.68 billion to businesses in respect of business insurance claims. No figures are available for the number of claims. If the average claim were £50,000 there would be 33,600 claims. This demonstrates that there cannot be more than 33,600 significant claims of more than £50,000, and there are probably far fewer.¹⁰
- 21.16 Using an estimate of around 20,000 significant business property claims in a “normal” year, we have attempted to predict the likely number of damages payments, following unreasonable delay. Out of the 20,000 claims, the insurer will have unreasonably delayed payment in only a small proportion. In the Broking Now! survey, 40% of brokers reported no evidence of delay in any cases; out of the remaining 60%, almost half reported delay in less than 5% of cases. If unreasonable delay were to occur in 2% of cases, this would suggest a total pool of around 400 cases each year.
- 21.17 Our proposals are cautious. To found a claim for damages for late payment, the insured business must show that:
- (1) *It has a valid claim.*
 - (2) *The insurer is responsible for unreasonable delay.* The time will not start to run until the insured has submitted a “clean claim”, providing all the material information. The insurer would then have sufficient time to carry out a full investigation, including time to seek information from third parties.
 - (3) *It has suffered actual loss.* This would never be presumed and must be proved in each case.
 - (4) *The loss was caused by the unreasonable delay.*
 - (5) *The loss was foreseeable,* in that it was within the “reasonable contemplation” of both parties at the time the contract was made.
 - (6) *It took all reasonable steps to mitigate its loss,* for example, borrowing money for repairs where necessary.
 - (7) Where damages are excluded or limited by contract, *the decision was not one which an insurer acting in good faith could have taken.* This would protect insurers who had good reasons for thinking that they were not liable to pay even if their decision later turned out to be wrong.
- 21.18 This seven stage process means that the number of successful claims is likely to be low. Furthermore, the intended effect of the proposal is to encourage insurers to give due emphasis to prompt payment, rather than to encourage compensation claims after the event. Thus the level of unreasonable delay is expected to fall.

¹⁰ Although this could rise significantly following a major flood.

- 21.19 Therefore, we think that the number of cases meeting the criteria for payments will be small – possibly no more than 100 out of the 400 claims identified. And in only a small proportion would the unreasonable delay lead to significant loss. As the survey of brokers showed, most cases involve only small losses of around £2,000. Only a small proportion (less than 5%) involves significant losses of more than £100,000.
- 21.20 Experience in Scotland also suggests that payments are likely to be low. Although damages for late payment are available in Scotland, insurers told us that this has no effect on pricing business insurance sold in Scotland.
- 21.21 In the impact assessment, we attempt to estimate the scale of the likely damages for late payment. We suggest a range of £500,000 to £1.2 million. We welcome views on these estimates.
- 21.22 **How many claims for damages for late payment are likely to be paid each year? And what would be the average size of each claim?**
- 21.23 **We invite comments on the view that total payments for damages for late payment may be in the region of £500,000 to £1.2 million.**

Additional court cases

- 21.24 Where claims are not dealt with by FOS, there would be additional court cases generated by claims for compensation. We have not been able to estimate the costs. Claims for compensation are rarely brought on their own, but are usually added to litigation to obtain the insurance payment itself.
- 21.25 That said, we think these additional costs are likely to be low. Businesses making claims against insurers must pay for their own legal costs, and risk paying the insurer's legal costs should they lose. The "loser pays" rule acts as a strong disincentive to speculative or ill-advised claims.
- 21.26 **What, if any, additional legal costs would be generated by the proposals?**

INSURERS' REMEDIES FOR FRAUDULENT CLAIMS

- 21.27 Fraud is a serious and expensive problem. Research by the ABI showed that in 2010, insurers detected 133,000 fraudulent general insurance claims (or 1.5% of all claims). This represented a 9% increase from 2009.¹¹ The value of these claims amounted to 4.8% of the value of all claims paid. In addition, insurers detected 1,076 fraudulent long term insurance claims.
- 21.28 The value of undetected fraud is much greater. In 2009, the ABI estimated that undetected fraud in general insurance claims totalled £1.9 billion a year.
- 21.29 ABI research in August 2010 looked in detail at ways in which general insurance fraud could be deterred.¹² Surveys have found that the British public shows some moral ambivalence towards insurance fraud. Thus a strategy to combat fraud involves several elements. There needs to be publicity for the sanctions that will

¹¹ ABI, Data Bulletin: Detected Fraud in General and Long-Term Insurance (June 2011).

¹² ABI, Research Brief: Deterring Opportunistic General Insurance Fraud (August 2010).

be imposed, together with persuasion that fraud is wrong, and that insurers do not behave unfairly to “get out” of payment.

21.30 The reforms proposed in Chapter 2 would be part of this strategy.

Benefits

21.31 The main benefit of our proposal is improved deterrence. The estimated volume of insurance fraud is so great that even a very small change in behaviour can result in significant benefits. If the proposals were to reduce the cost of fraud by only 0.1% (one thousandth) the savings would amount to £1.9 million. Thus a very small fall in fraud would produce significant savings, possibly in the order of £2 million to £5 million. We welcome views on these suggested savings.

21.32 Given that insurance fraud is an issue which generates legal argument,¹³ we also think that clearer rules would lead to some reduction in legal costs.

21.33 **Do consultees agree that the proposed reforms to insurers’ remedies for fraudulent claims will provide benefits in terms of improved deterrence and reduced legal costs?**

21.34 **We invite comments on the view that the reforms (when combined with effective publicity) would reduce fraud, leading to savings of around £2 million to £5 million a year.**

Costs

21.35 The main costs are one-off costs of familiarisation, discussed below. We do not think that there would be any ongoing costs to removing legal uncertainty in this area.

INSURABLE INTEREST

21.36 The proposals in Chapter 3 have two objectives:

- (1) To clarify and restate the law on insurable interest for general insurance (on land or goods). We propose to repeal unnecessary statutes, including the Marine Insurance Act 1788 and the Marine Insurance (Gambling Policies) Act 1909.
- (2) To broaden the categories of those who may insure the life of another. For example, we propose to permit insurance on the life of another where the policyholder has a real probability of incurring economic loss on the other’s death.¹⁴

¹³ A search of Westlaw showed that in the past two years, there have been three insurance fraud cases reported in the County Court and seven insurance fraud cases were reported in the High Court. Of these, three were taken to the Court of Appeal.

¹⁴ For a critical analysis of the shortcomings of the current law see *An Analytical Perspective on the Requirements of Insurable Interest in Life Insurance Contracts*, Chapter 4, Dr Oluwadamilola Oluyemisi Awoye, University of Manchester, School of Law, (PhD thesis, 2011).

21.37 We look at each in turn.

Clarifying the law

21.38 Both the Marine Insurance Act 1788 and the Marine Insurance (Gambling Policies) Act 1909 appear moribund, and we do not think that their repeal would have any direct effect. Nevertheless, we think there is an advantage in repealing unnecessary statutory requirements. As the Government's red tape challenge has made clear, the default position should be that regulations should be repealed, unless they can be shown to be beneficial. This is especially true of statutes which create criminal offences. The existence of trivial, unused, and unnecessary criminal offences brings the law into disrepute, devaluing the moral authority of criminal sanctions.

21.39 The provision of a sole statutory source for the requirement for insurable interest will remove confusion about how and when it is imposed, and it will establish a marker by which insurance products can be clearly differentiated from any other risk transfer transaction, such as gambling or the trade in derivatives.

Broadening the categories of life insurance

21.40 The law appears out-of-step with current practice. We think it would be beneficial to resolve differences between law and practice in this area. It is also possible that the existence of legal restrictions discourages insurers from writing insurance business which is beneficial and for which there is a market.

21.41 One possible use of life insurance would be to allow relatives to insure the lives of those on whom they depend for financial and practical help. For example, under our proposals elderly people would be entitled to insure the life of a son, daughter or other person, on whom they depend for their care, whether that is provided in person or financially. The Dilnot Commission on Funding of Care and Support has drawn attention to the major problems society faces in providing and paying for adult social care.¹⁵ Enabling people to insure the lives of those who care for them would be one small way of providing possible new options in this market.

21.42 More generally, there is an urgent need to encourage people to make greater provision for old age, bereavement and illness. In 2010 Swiss Re looked at the difference in the insurance held and insurance needed in terms of total sums assured and estimated the "Life Assurance Protection Gap" at £2.4 trillion. The proposals would allow firms to develop new products to fill this gap.

21.43 The proposals may also provide possible new business opportunities allowing relatives to insure the lives of those on whom they depend for financial and practical help and encourage people to make greater provision for old age, bereavement and illness.

21.44 Overall this is a moderate deregulatory measure. We do not think that there are any costs associated with it. There may be some modest benefits in terms of increased activity through greater sales.

¹⁵ See www.dilnotcommission.dh.gov.uk.

- 21.45 **We welcome comments on the costs and benefits of our proposals on insurable interest.**

POLICIES AND PREMIUMS IN MARINE INSURANCE

- 21.46 The proposals in Chapter 4 are in two main parts: to repeal the requirement for a formal marine policy and to clarify the law on broker's liability to pay premiums to the insurer. We look at each in turn.

Formal marine policies

- 21.47 We propose to repeal the requirement in section 22 of the Marine Insurance Act 1906 that a contract of marine insurance must be embodied in a marine policy. The requirement has become moribund, and its repeal is unlikely to have a practical effect. As the International Underwriting Association put it:

The practical effect would be negligible given that the market has essentially moved away from the formal requirement to produce a policy and generally does not rely upon section 22 in contract disputes.

- 21.48 Nevertheless, we think it would be beneficial to remove unnecessary complexities in the law. The UK is one of the world's leading insurance law jurisdictions, and outdated and unused provisions undermine the respect in which the law of the UK is held.

Brokers' liability for premiums

- 21.49 We propose to clarify the law on a broker's liability to pay premiums to the insurer. Our proposal would have two benefits.

(1) *It would reduce the risks to insurers should a marine broker become insolvent.* At present, the insolvency of a marine broker is likely to generate difficult and uncertain litigation. As the broker market consolidates, the effects of a major insolvency could be large and destabilising. For example, the turnover of some of the world's largest broking firms now exceeds £5 billion.¹⁶ Although we cannot quantify the costs of the legal uncertainty following a broker's insolvency, we think that the risks are sufficiently significant to justify their removal.

(2) *It would be easier for brokers and insurers to agree rules on liability for premiums, to reflect the position which best suited their needs.* We have proposed a default rule which most closely reflects current practice: namely that where a policyholder fails to pay, the insurer may seek payment from the broker. This rule could, however, be excluded easily.

- 21.50 We do not think that these proposals would have any cost for the insurance industry.

¹⁶ For further details of broker turnover, see the Impact Assessment.

21.51 **We welcome comments on the costs and benefits of our proposals on policies and premiums in marine insurance.**

TRANSITIONAL COSTS

21.52 Any new Bill will, inevitably, require a one-off process of familiarisation and training, as those affected by law need to understand the effect of the new rules. We do not anticipate that these will be large. Insurers provide regular training for claims staff in any event, and we think the effect of the new measures could be absorbed into the firms' normal training activities.

21.53 The transitional costs of the recent Consumer Insurance (Disclosure and Representations) Bill were estimated at between £1 million and £1.5 million. We think that the transitional costs for these proposals may be of a similar order of magnitude and we welcome views on this.

21.54 **What are the likely transitional costs of these proposals, in terms of training and familiarisation? We invite comments on the view that such costs may be between £1 million and £1.5 million.**

PART 22

LIST OF PROPOSALS AND QUESTIONS

22.1 We ask for comments and responses to the following questions:

DAMAGES FOR LATE PAYMENT

A statutory duty to pay valid claims

22.2 Do consultees agree that legislative reform should provide that:

- (1) insurers should be under a contractual obligation to pay valid claims within a reasonable time; and
- (2) an insurer who fails to meet this obligation should be liable to pay damages for any foreseeable losses which result? (5.9)

The definition of a reasonable time

22.3 Do consultees agree that:

- (1) provided the insurer has acted reasonably in asking the insured for information to enable it to investigate the claim, the time to investigate should only begin once the insured has provided the insurer with all the material information requested?
- (2) the insurer should have sufficient time to carry out a full investigation, including time to seek information from third parties where necessary?
- (3) once it has investigated, the insurer should assess the claim and arrive at and communicate its decision promptly?
- (4) overall, the insurer should have a reasonable time to investigate and assess the claim, taking into account market practice, the type of the insurance, and the size, location and complexity of the claim? (5.14)

Business insurance: an excludable duty

22.4 Do consultees agree that in business insurance:

- (1) insurers should be able to limit or exclude their liability to pay damages for late payment through a term of the contract; and
- (2) the term should only apply if the insurer has acted in good faith? (5.19)

Consumer insurance: a non-excludable duty

22.5 Do consultees agree that in consumer insurance, insurers should not be able to limit or exclude their liability to pay damages for late payment? (5.25)

A “shield” of good faith in business insurance

- 22.6 Do consultees agree that an insurer should not be entitled to rely on an exclusion clause to limit liability for a delayed payment or a rejected claim where it has not acted in good faith? (5.32)
- 22.7 Do consultees agree that where an insurer seeks to rely on an exclusion clause:
- (1) the insurer should explain to the insured why the payment was delayed or rejected; and
 - (2) the court should evaluate whether the insurer was acting in good faith, given the circumstances and the information available to it at the time? (5.33)

The test for good faith

- 22.8 Do consultees agree that legislation should not include further guidance on good faith in claims handling? (5.37)

Limitation of actions

- 22.9 Do consultees agree that the limitation period in England and Wales to sue an insurer for a claim should commence only after an insurer has had a reasonable time to investigate and assess the claim? (5.47)
- 22.10 Alternatively, should the limitation period in England and Wales commence:
- (1) at the time of loss; or
 - (2) at the time the insurer’s decision about the claim was communicated to the insured? If so, please comment on when in the claim’s process you think this should be. (5.48)

Damages for distress and inconvenience in consumer insurance

- 22.11 Do consultees agree that damages for distress and inconvenience or discomfort should be available for consumer insurance policies? (5.55)
- 22.12 Should this be achieved through statutory reform? (5.6)

INSURERS’ REMEDIES FOR FRAUDULENT CLAIMS

Insurers’ remedies for fraud

- 22.13 Do consultees agree that a policyholder who commits a fraud should:
- (1) forfeit the whole claim to which the fraud relates?
 - (2) also forfeit any claim where the loss arises after the date of the fraud?
 - (3) be entitled to be paid for any previous valid claim which arose before the fraud took place? (8.17)
- 22.14 Do consultees agree that the definition of “the whole claim” should be left to the courts? (8.18)

22.15 Do consultees agree that the costs of investigating proven fraud should be recoverable if the insurer can show that the costs were:

- (1) actually incurred?
- (2) reasonable and proportionate in the circumstances?
- (3) not offset by any saving from legitimate, forfeited claims? (8.23)

Express terms

Business insurance

22.16 Do consultees agree that in business insurance:

- (1) the remedies for fraud should be subject to an express term of the contract?
- (2) a clause which changes the statutory remedies, should be written in clear, unambiguous terms and specifically brought to the attention of the other party? (8.27)

Consumer insurance

22.17 Do consultees agree that in consumer insurance, any term which purports to give the insurer greater rights in relation to fraudulent claims than those set out in statute would be of no effect? (8.30)

Insurers' remedies for fraud: co-insurance and group insurance

22.18 Do consultees have evidence that the law of fraudulent claims by joint insureds causes problems in practice? If so, we would be grateful if consultees could provide us with such evidence or examples, and also provide us with information on how these issues were dealt with (either by the firm concerned or by any other body). (9.21)

22.19 Do consultees agree that there is no need to legislate on the effect of fraud by one joint insured on the other joint insured's claim? (9.22)

22.20 Do consultees agree that a fraudulent act by one or more group members should be treated as if the group member concerned was a party to the contract? (9.30)

INSURABLE INTEREST

Indemnity insurance

A statutory base for insurable interest

22.21 Do consultees agree that there should be a statutory requirement that an insured has an insurable interest in the subject matter of the insurance?(12.42)

Timing and consequences

22.22 Do consultees agree that:

- (1) to make a claim, the insured must show insurable interest at the time of loss?
- (2) an insurance contract is void for lack of insurable interest unless there is a real probability that a party would acquire some form of insurable interest at some stage during the life of the contract?
- (3) if the insured shows that the contract was void for lack of insurable interest, the insurer may not sue for premium, and the insured is entitled to a refund of premiums already paid? (12.50).

Repealing the Marine Insurance (Gambling Policies) Act 1909

- 22.23 Do consultees agree that the Marine Insurance (Gambling Policies) Act 1909 should be repealed? (12.53)

Repealing the Marine Insurance Act 1788

- 22.24 Do consultees agree that the Marine Insurance Act 1788 should be repealed? (12.56)

Retaining the provisions on insurable interest in the Marine Insurance Act 1906

- 22.25 Do consultees agree that, for marine insurance, sections 4 to 15 of the Marine Insurance Act 1906 should be left as they are? (12.59)

Defining insurable interest for indemnity insurance

- 22.26 Should the statute state that an insured has an insurable interest if the insured has:

- (1) a right in the property which is the subject matter of the insurance or a right arising out of a contract in respect of it;
- (2) a real probability either of an economic benefit from the preservation of the insured subject matter, or of an economic loss on its destruction, which would arise in the ordinary course of things; or
- (3) possession of the insured subject matter? (12.66)

- 22.27 Should other forms of insurable interest be included in the list? (12.67)

- 22.28 Should the list be non-exhaustive? (12.68)

- 22.29 Alternatively, should the definition of insurable interest be left entirely to the courts? (12.69)

Life insurance

Insurable interest based on economic loss

- 22.30 Do consultees agree that an insurable interest may be found where there is a real probability that the proposer will retain an economic benefit on the preservation of the life insured or incur an economic loss on the death? (13.74)

- 22.31 Should the law require that the value of the policy is a reasonable valuation, made at the time of the contract, of the possible loss? (13.75)

Insurance without evidence of economic loss

CHILDREN UNDER 18

- 22.32 Do consultees agree:
- (1) that parents should be entitled to take out insurance on the life of a child under 18?
 - (2) that the right would extend to the legal parents of a child and all those who treated a child as a child of the family? (13.84)
- 22.33 Do consultees consider that there should be a cap on the amount for which children's lives may be insured? (13.85)
- 22.34 If the amount is capped we welcome views on what the amount should be and on how it should be set. (13.86)

COHABITANTS

- 22.35 Do consultees agree that a person should have an insurable interest in the life of another, irrespective of whether they can show economic loss, where they have lived in the same household as spouses (husband, wife or civil partner) during the whole of the period of five years ending immediately before the contract of life insurance is taken out? (13.103)

TRUSTEES OF PENSION OR GROUP SCHEMES

- 22.36 Should the statute clarify that trustees of pension and other group schemes have an unlimited insurable interest in the lives of the members of the scheme? (13.106)
- 22.37 Should an employer also have an unlimited interest in the lives of its employees when entering into a group scheme whose purpose is to provide benefits for its employees or their families? (13.107)

Repealing section 2 of the Life Assurance Act 1774

- 22.38 Do consultees agree that section 2 of the Life Assurance Act 1774 should be repealed? (13.110)

A new statutory requirement for insurable interest

- 22.39 Do consultees agree that:
- (1) a new statutory requirement for insurable interest should replace that set out in the Life Assurance Act 1774?
 - (2) if insurable interest is not present, the contract would be void but not illegal?

- (3) for composite policies, where insurable interest was present for some part of the insurance but not others, the policy should be treated as separable?
 - (4) for contingency insurance, insurable interest must be present at the time of the contract? (13.115)
- 22.40 Should the statute provide a non-exhaustive definition of insurable interest in contingency insurance? (13.116)

POLICIES AND PREMIUMS IN MARINE INSURANCE

The need for a marine policy: proposals for reform

- 22.41 Do consultees agree that:
- (1) a marine insurance contract may be enforced even if it is not embodied in a formal policy document?
 - (2) the statute should not require a marine insurance contract to be in any particular form? (17.3)

Repeals

- 22.42 Do consultees agree that the following sections of the Marine Insurance Act 1906 should be repealed:
- (1) Section 22? (17.7)
 - (2) Section 23?(17.11)
 - (3) Section 24(1)? (17.14)
 - (4) Section 89? (17.17)
 - (5) The model policy referred to in section 30 and contained in the First Schedule? (17.20)
 - (6) Section 52? (17.23)

Reforms

Where policy means contract

- 22.43 Do consultees agree that most references to policies in the 1906 Act should be interpreted as references to marine insurance contracts? (17.26)

Section 2(2): activities analogous to a marine adventure

- 22.44 Do consultees agree that where an insurance contract covers shipbuilding, a ship launch or “any adventure analogous to a marine adventure”, the parties may include an express term to designate the insurance as marine insurance for the purposes of the 1906 Act? This would apply the provisions of the Act “in so far as applicable”. (17.32)

- 22.45 Alternatively, should section 2(2) be repealed, leaving the parties free to apply any specific provision of the Act to the policy? (17.33)

Section 21: when contract concluded

- 22.46 Do consultees agree that the following words should be removed from section 21?

whether the policy be then issued or not; and, for the purpose of showing when the proposal was accepted, reference may be made to the slip or covering note or other customary memorandum of the contract. (17.36)

Section 50(3): assigning a policy

- 22.47 Should section 50(3) be amended to say that a marine insurance contract may be assigned in any customary manner or as agreed between the parties to the transfer? (17.39)
- 22.48 Are there any other issues or related matters which we should take account of in relation to our proposal to amend section 50(3)? (17.40)

The broker's liability for premium

The policyholder should be liable to the insurer for premiums

- 22.49 Do consultees agree that where marine insurance is effected on behalf of an insured by a broker:
- (1) the policyholder should be liable to pay the insurer?
 - (2) when the broker collects the premium, policyholders should pay the broker as an agent?
 - (3) as a general rule, the broker should hold the premium as agent for the policyholder, but this should be subject to a contract between broker and insurer?
 - (4) the broker's liability to pay premiums to the insurer should be a matter of agreement between broker and insurer? (19.22)

A default rule that marine brokers are responsible for premiums?

- 22.50 Do consultees agree that where a marine insurance contract is effected on behalf of a policyholder by a broker:
- (1) the default rule should be that the broker is jointly and severally liable with the insured to pay the premium to the insurer?
 - (2) the broker and insurer should be able to contract out of this provision?
 - (3) the default rule should apply equally to initial and adjusted premiums?

- (4) the default rule should apply whenever the broker/insurer relationship is governed by English or Scots law, irrespective of the law under which the insurance contract is written? (19.31)

The broker's lien and other provisions

- 22.51 Do consultees agree that section 53(2) should be repealed and replaced by a new provision which applies to both marine and non-marine insurance? (20.31)
- 22.52 Do consultees agree that the statute should provide that where the broker is obliged to pay any premium to the insurer and has done so:
- (1) the broker should be entitled to exercise the insurer's rights to recover the debt from the policyholder?
 - (2) the broker should have a statutory right to set off any premium or commission against the proceeds arising from that policy?
 - (3) where no third party interests are involved, the broker should have a general right to set off any debt owed to it by the insured against any money held by the broker on behalf of the insured? (20.32)
- 22.53 We welcome views on how third party interests should be defined. (20.33)

Section 54

- 22.54 Do consultees agree that section 54 should be repealed? (20.39)

ASSESSING THE IMPACT OF REFORM

Damages for late payment

- 22.55 What are the likely benefits if prompt payment prevents businesses from ceasing to trade? We invite comments on the view that such benefits may exceed £5 million. (21.13)
- 22.56 How many claims for damages for late payment are likely to be paid each year? And what would be the average size of each claim? (21.22)
- 22.57 We invite comments on the view that total payments for damages for late payment may be in the region of £500,000 to £1.2 million. (21.23)
- 22.58 What, if any, additional legal costs would be generated by the proposals? (21.26)

Insurers' remedies for fraudulent claims

- 22.59 Do consultees agree that the proposed reforms to insurers' remedies for fraudulent claims will provide benefits in terms of improved deterrence and reduced legal costs? (21.33)
- 22.60 We invite comments on the view that reforms (when combined with effective publicity) would reduce fraud, leading to savings of around £2 million to £5 million a year. (21.34)

Insurable interest

- 22.61 We welcome comments on the costs and benefits of our proposals on insurable interest. (21.45)

Policies and premiums in marine insurance

- 22.62 We welcome comments on the costs and benefits of our proposals on policies and premiums in marine insurance. (21.51)

Transitional costs

- 22.63 What are the likely transitional costs of these proposals, in terms of training and familiarisation? We invite comments on the view that such costs may be between £1 million and £1.5 million. (21.54)

APPENDIX 1

LIST OF RESPONDENTS TO RELEVANT ISSUES PAPERS

We are particularly grateful to Derrick Cole who responded to all of the Issues Papers and who died suddenly in March 2011. His comments and advice drawn from his extensive knowledge of the law and experience in the industry will be sadly missed.

ISSUES PAPER 4: INSURABLE INTEREST

The Institute of Insurance Brokers

Association of British Insurers

International Underwriting Association

Lloyd's Market Association

Derrick Cole and Geoffrey Lloyd

City of London Law Society

Financial Services Authority

RBS Insurance

Faculty of Advocates

Reinsurance Group of America

Swiss Re

Aviva plc

Royal & Sun Alliance plc

Zurich Financial Services (Government and Industry Affairs)

Zurich Financial Services (UK General Insurance Legal Unit)

Margarida Lima Rego

Heather Thomas

Lawrence Graham LLP

Adrian Hamilton QC

Association of Friendly Societies

Nicolas Legh-Jones

Aegon UK

International Swaps and Derivatives Association

Standard Life plc

ISSUES PAPER 6: DAMAGES FOR LATE PAYMENT AND THE INSURER'S DUTY OF GOOD FAITH

Association of British Insurers

International Underwriting Association

Lloyd's Market Association

Derrick Cole and Geoffrey Lloyd

British Insurance Brokers' Association

The General Council of the Bar

British Insurance Law Association

City of London Law Society

RBS Insurance

Faculty of Advocates

Janan Al-Asady

Barrie Jervis

Geoff Wheatley (Theatreserve)

Jonathan Goodliffe

Prof John Birds

Peter Patient

Peter Franklin

Association of Financial Mutuals

Ince & Co

Financial Ombudsman Service

Reinsurance Group of America

AIRMIC

Forum of Insurance Lawyers

Groupama Insurances

Swiss Re

Herbert Smith LLP

Covington & Burling LLP

Lloyd's of London

Beachcroft LLP

ISSUES PAPER 7: THE INSURED'S POST-CONTRACTUAL DUTY OF GOOD FAITH

Association of British Insurers

International Underwriting Association

Lloyd's Market Association

Derrick Cole and Geoffrey Lloyd

Financial Services Authority

The General Council of the Bar

British Insurance Law Association

RBS Insurance

Faculty of Advocates

Peter Patient

Financial Ombudsman Service

Forum of Insurance Lawyers

Swiss Re

Beachcroft LLP

Prof Robert Merkin

Roy Rodger

CIFAS

Association of Financial Mutuals

Ray Hodgkin

International Group of P&I Clubs

Aviva plc

Keoghs LLP

Royal & Sun Alliance Insurance plc

QBE European Operations

Zurich Insurance plc

Kennedys LLP

Faculty of Advocates

Geoff Lord

Prof Howard Bennett

ISSUES PAPER 8: THE BROKER'S LIABILITY FOR PREMIUMS

Association of British Insurers

International Underwriting Association

Lloyd's Market Association

Derrick Cole and Geoffrey Lloyd

British Insurance Brokers' Association

London and International Brokers' Association

Marsh and Guy Carpenter

Adam Samuel

The General Council of the Bar

British Insurance Law Association

City of London Law Society

Financial Services Authority

Harbour Insurance Brokers Ltd

Institute of Insurance Brokers

Munich Re

Faculty of Advocates

RBS Insurance

Lord Justice Longmore

ISSUES PAPER 9: THE REQUIREMENT FOR A FORMAL MARINE POLICY

Association of British Insurers

International Underwriting Association

Lloyd's Market Association

Derrick Cole and Geoffrey Lloyd

British Insurance Brokers' Association

London and International Brokers' Association

Marsh and Guy Carpenter

Adam Samuel

The General Council of the Bar