



**Law
Commission**
Reforming the law


Scottish Law Commission
promoting law reform

Reforming Insurance Contract Law

A Summary of Responses to Consultation

This document summarises the responses on business issues to the Law Commissions' Consultation Paper: *Insurance Contract Law: Misrepresentation, Non-disclosure and Breach of Warranty by the Insured*. (Law Com No 182 / Scot Law Com No 134)

October 2008

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PART 1

INTRODUCTION

PURPOSE OF THIS PAPER

- 1.1 The Law Commission of England and Wales and the Scottish Law Commission published their joint Consultation Paper on misrepresentation, non-disclosure and breach of warranty by the insured in July 2007. That paper made provisional proposals and asked questions in relation to both business and consumer insurance.
- 1.2 This document summarises the responses which the Law Commission and the Scottish Law Commission have received to their joint consultation in relation to business insurance. It is a factual document and does not set out the views of either Commission. It is issued by the team conducting the review, with the purpose of reporting the arguments which have been put to us. **The Law Commissions have not yet formulated their recommendations on this subject.**

APPROACH

- 1.3 For each proposal or question, we give a limited amount of context and background information about the reasons why the Law Commissions made the proposal or asked the question. However, for a full explanation of our proposals, readers are referred by the number in brackets back to the Consultation Paper.
- 1.4 We then attempt to summarise the written responses we received, indicating the spread of opinion on a particular point. We are looking at the quality of argument rather than simply counting numbers. This would not be appropriate: for example some organisations speak on behalf of many members; others are sent on behalf of individuals.
- 1.5 Next we outline the arguments raised both for and against our proposals. We have provided a few quotations from those responses which were not sent on a confidential basis. We hope that these will give a flavour of the arguments raised. However, in a paper of this length, we have needed to be selective. Many other points were made which we have not quoted in the paper, but which will be taken into account when formulating our views.
- 1.6 Finally we attempt to give an overview of responses.

THANKS

- 1.7 Consultees have produced detailed and well-argued documents that set out arguments both for and against our proposals. Many people have clearly devoted considerable time and resources to this project. We would like to thank all those who have sent written responses to our Consultation Paper and met us to discuss their views.
- 1.8 We are not inviting comments at this stage. However, if, having read this paper, anyone does wish to put additional points to the Commissions we would be pleased to receive them.

1.9 Please contact us by email at commercialandcommon@lawcommission.gsi.gov.uk or by post addressed to Elizabeth Waller, Law Commission, Steel House, 11 Tothill Street, London SW1H 9LJ.

PART 2

BACKGROUND

AREAS COVERED

- 2.1 Our analysis of insurance contract law in the Consultation Paper found that there were six areas of insurance contract law which could cause concern:
- (1) The current duty of disclosure can operate as a trap. A policyholder is required to disclose all information which is material to the hypothetical prudent insurer, whether the policyholder is asked for that information or not. Many businesses, particularly small businesses, do not know what would influence the judgment of a prudent insurer. If they do not disclose the correct information, the insurer can avoid the contract and refuse to pay claims.
 - (2) Policyholders may be denied claims even when they act honestly and reasonably. An insured who misunderstands a question asked by an insurer and who reasonably thinks that a piece of information is not relevant to the insurer, may find that the insurer can avoid the policy. The same is true if the insured has given factual information which is inaccurate, or only partly accurate, even though the insured honestly and reasonably believed that what they said was correct.
 - (3) The law on warranties of past or present facts can also lead to harsh results. If an insured makes a statement which is deemed to be a warranty and that statement is not correct, the law states that the insurer is entitled to be discharged from liability. This is the case even if the statement is not material and would not have influenced the judgment of a prudent insurer in fixing the premium or determining whether it will take the risk.
 - (4) Basis of the contract clauses can be used to convert all statements on a proposal into warranties. If the policyholder signs a statement that all the answers and information he has given “forms the basis of the contract” this has the effect of converting all the answers into warranties. Therefore the insurer may avoid the contract for any inaccuracy, even one that did not increase the risk.
 - (5) In the case of warranties of future conduct, the law states that the policy is also discharged even if the breach of warranty is later remedied or had nothing to do with the loss suffered. The effect is that the law will allow a policy to be avoided for the smallest inaccuracy, if that statement is deemed to be a warranty.
 - (6) An intermediary can introduce inaccuracies into the disclosures made by a policyholder by failing to pass on accurately the information it has been given by the policyholder. The risk of misrepresentations, non-disclosures and breaches of warranty arising in this way is borne by the intermediary’s principal. However, working out who the intermediary’s principal is can often be difficult.

2.2 This therefore was the scope of our project for businesses insurance. Business insurance policies cover a huge spectrum, from a sole trader insuring his corner shop premises to a multinational public limited company insuring global liabilities. The challenge for us was to draft a scheme which would cover that spectrum without unnecessarily interfering with freedom of contract.

RESPONSES

2.3 Since the Consultation Paper was published we have received 105 written responses from consultees and attended over 50 meetings with buyers, insurers, brokers, lawyers and representative groups. The table below classifies those who wrote the 105 responses we received.

Table 1: Respondents to the Consultation Paper, by category

<i>Type of respondent</i>	<i>Number</i>
Insurers and insurance trade associations	39
Lawyers, legal representative associations and the judiciary	25
Brokers and brokers' associations	13
Consumer insureds and consumer groups	7
Business insureds and representative associations	8
Academics	5
Other	8
Total	105

2.4 Several of those 105 consultees do not work in the business market and therefore made comments only in relation to our proposals for consumer insurance. Between 50 and 65 respondents made comments on a substantial number of business proposals. We identified 58 respondents who addressed four out of the first eight questions and we categorise them in Table 2.

Table 2: Respondents who provided substantive responses to business issues.

Type of respondent	Respondents who provided substantive responses to business issues	
	Number	%
Insurers and insurance trade associations	26	45
Lawyers, legal representative associations and the judiciary	16	28
Brokers and brokers' associations	7	12
Consumer insureds and consumer groups	1	2
Business insureds and representative associations	2	3
Academics	3	5
Other	3	5
Total	58	100%

DEFINING BUSINESS

- 2.5 Business insurance is not defined in our Consultation Paper and the majority of consultees appeared to agree that it did not need a definition. It is usually clear when the policyholder is a business. However, some difficulty may arise over mixed-use policies where, for example, a home worker insures his PC as part of his domestic contents policy. Here it is necessary to look at our definition of consumer insurance. We have defined consumer insurance as insurance entered into by an individual wholly or mainly for purposes unrelated to his business. So if the value of the PC formed a minor part of the valuation for the home worker's contents insurance, that home worker would be treated as a consumer.

- 2.6 A small number of respondents asked whether we could link our definition with the definition of consumer and commercial customer issued by the Financial Services Authority (FSA). A commercial customer is defined by the FSA as “a customer who is not a consumer”.¹ However, their definition of consumer is narrower than ours. Their guidance states that “if a customer is acting in the capacity of both a consumer and a commercial customer in relation to a particular contract of insurance, the customer is a commercial customer”.² This would mean that the home worker, discussed above, could be treated as a commercial customer by the FSA. For the purposes of the FSA rules this would make little difference as their new Insurance Conduct of Business Rules (ICOBS) do not draw sharp distinctions between businesses and consumers. However for the purposes of our proposals the distinction will be more significant. Therefore, the FSA definition of consumer is not appropriate to our proposed regime.³

NEED FOR REFORM

- 2.7 Some insurers felt that there was no need for reform of the law. The Association of British Insurers (ABI) said that “the insurance industry is not convinced of the need for reform of the law in this area”. Other insurers, responding individually, warned us that it would be dangerous to interfere in this area. They disagreed that the law was unclear and felt that reform would destroy the current tried-and-tested system and make UK law less attractive to buyers of insurance.
- 2.8 A point which was not often openly expressed but which was occasionally mentioned to us in consultation meetings was that changing the law would put insurance companies at a commercial disadvantage. If the proposed default regime became the starting point for contract negotiations, insurers feared that they would have less negotiating power against buyers of insurance and that they would be exploited by them.
- 2.9 A point which was more directly expressed was that it was inappropriate for businesses to be given any extra protection. Businesses should instead take steps to protect themselves. Fortis Insurance Limited spoke for many insurers when it said

businesses must be prepared to seek expert advice in the same way that they must employ accountants to organise their financial affairs and lawyers to organise their legal affairs. [Fortis Insurance Limited]

- 2.10 Amongst buyers of insurance and many brokers, however, there was clear support for reform. Several told us that they found the current law unhelpful. One large transport infrastructure business wrote:

While as a team we are of course aware of the principles of the law regarding disclosure, misrepresentation and warranties, we perhaps had not appreciated the full extent of the burden the law imposes on a purchaser of insurance. [Network Rail]

¹ Financial Services Authority *Insurance: New Conduct of Business Sourcebook*, 2.1.1(4).

² Financial Services Authority *Insurance: New Conduct of Business Sourcebook*, 2.1.3.

³ We discuss this point further at paragraph 2.18 of our consumer summary paper.

- 2.11 The Construction Industry Council agreed that the current law was unpredictable and could lead to harsh results.

There is little doubt that the current arrangements for insurance law are often little understood, even by relatively informed buyers of insurance, resulting in unexpected, unfair and unjust outcomes – more so with some insurers than others. [Construction Industry Council]

- 2.12 Two large financial institutions admitted that they had enough bargaining power to negotiate insurance contracts to their satisfaction. They pointed out, however, that there are a huge number of businesses which have a turnover of more than £1 million (and are therefore outside the ombudsman's jurisdiction) which lack the ability to protect themselves. One financial institution also said that, at present, they have little confidence in the outcome of any claim and are unhappy with the amount of risk they still have to bear, despite having purchased insurance. Another said that insurance is sometimes viewed as "a right to sue an insurance company rather than a clear contract to pay after a given event".
- 2.13 These financial institutions told us that, over the last few years, they have transferred more of their risks into their captives,⁴ and are intending to place more risks with captives in the future. They are also looking at the possibility of creating mutualised insurance funds to avoid having to deal with external insurers.
- 2.14 Many businesses are not large corporate entities. Results from National Statistics show that nearly 70% of UK businesses have no employees and are run and staffed by the same person. Such businesses will in the vast majority of cases have no more knowledge than consumers as to what is expected of them when they provide information. The Financial Ombudsman Service (FOS) can hear business insurance cases where the turnover of the business does not exceed £1 million but at present very few businesses take up this service.
- 2.15 Even for larger businesses, the current law seems to cause disquiet. Buyers told us that, whilst it was not for the law to 'molly-coddle' businesses, change was necessary. Network Rail felt that such a move was not likely to come from within the insurance industry itself and that outside assistance was necessary.

Industry self-regulation has shown to be largely ineffective, particularly for business buyers. Pressures placed on insurers by the insurance market cycle have prevented change. Too often a policyholder will be reliant on the insurer's goodwill in order that a claim is not rejected due to a technical breach of the current law. The legal basis of insurance contracts needs a clear shift. [Network Rail]

⁴ Captives are subsidiary companies formed to insure, or reinsure, the risks of the parent company or group.

- 2.16 The Association of Insurance and Risk Managers (AIRMIC), which represents the insurance buyers and risk managers of about 75% of the UK FTSE 100 group of companies, welcomed the proposals. AIRMIC states that its members spend about £5 billion on annual insurance premiums, an estimated £500 million on brokers and other service providers and a further £2 billion of premium on captive insurance companies. They believed that the proposals move “towards the AIRMIC desired position in relation to insurance contracts of contract clarity”. They went on to say in a press release dated 12 November 2007 that; “our only concern is that past attempts at reforming insurance law have come unstuck. This time we hope and expect to see change become a reality”.
- 2.17 Most buyers are risk adverse; that is why they buy insurance. They want to pass the risk of innocent and reasonable non-disclosure to the insurer, even at the cost of a small increase in the premium. The Construction Industry Council wrote; “if that proves to be the case, so be it; more effective insurance arrangements should come at a price”.

STRUCTURE OF THIS PAPER

- 2.18 Part 3 of this Paper reports the responses we received to our proposals on misrepresentation and non-disclosure and warranties of past or present fact (the proposals and questions posed in Part 5 of our Consultation Paper). Part 4 of this Paper reports the responses we received to our proposals on warranties of future conduct (the proposals and questions posed in Part 8 of our Consultation Paper). Finally, Part 5 of this Paper reports the responses we received to our proposals on intermediaries (the proposals and questions posed in Part 10 of our Consultation Paper).

PART 3

NON-DISCLOSURE, MISREPRESENTATION AND WARRANTIES OF PAST AND PRESENT FACT

DISCLOSURE: INTRODUCTION

- 3.1 In the Consultation Paper we proposed that a business policyholder should be under a duty to volunteer material information when it enters into a contract of insurance (12.26).
- 3.2 This differs from our proposal for consumer policyholders who, we proposed, should not be subject to such a duty. There are several reasons for this difference. First, there is often no proposal form for business insurance. Instead the broker presents the risk and the underwriter relies on the broker and client to present that risk honestly. Second, business insurance covers a wider variety of unusual risks and it would be hard for insurers to ask questions about all relevant matters. Third, a greater proportion of business insurance is conducted through full-time professional intermediaries, so the risks of insureds not realising that they have a duty of disclosure is reduced.
- 3.3 However, as we set out in the Consultation Paper, we believe that the duty to volunteer information can be difficult for policyholders to understand. As a result we made two further proposals. These relate to the standard of disclosure:
- (1) that whether a particular fact is material or not should be assessed according to the standard of the reasonable insured, rather than the prudent insurer (12.31 and 12.32); and
 - (2) that the duty of disclosure should be limited to facts that the business insured knew or which it ought to have known (12.27 and 12.28).
- 3.4 Below, we look first at the duty of disclosure before turning to discuss the standard of materiality and whether the duty should be limited to facts which the insured knew or ought to have known.

RETAINING THE DUTY OF DISCLOSURE

- 3.5 We proposed that a duty of disclosure should continue to apply to business insurance (12.26).

Support for retaining the duty

- 3.6 We received sixty-two responses to this proposal. Fifty consultees (81%) agreed with the proposal and support came from both insurers and buyers.
- 3.7 The Association of British Insurers' (ABI) view was that it would be appropriate to retain a duty of disclosure in business insurance as business insurance involves more complex risks and businesses are not in need of special protection.

Insurers often rely on the insured's duty of disclosure as well as on their own means of information and enquiry. Businesses have access to expert advice (usually by way of brokers) and experience to understand the consequences of a non-disclosure. They are not in need of special protection to the same extent as retail consumers and should be able to choose to buy policies with a cheaper premium. This would allow the industry to remain internationally competitive. [ABI]

- 3.8 Broadly speaking, buyers, including AIRMIC, Network Rail and the Association for Consultancy and Engineering, agreed with the proposal to retain a duty of disclosure for businesses.

Arguments in favour of a single regime

- 3.9 However, eight consultees (13%) disagreed with retaining the duty of disclosure on business insureds,¹ including several brokers. These consultees felt that the consumer and business regimes should be consistent and that insurers ought to carry the burden of asking questions about matters they consider relevant.
- 3.10 The solicitors' firm K&L Gates LLP argued that, in the business context, insurers rather than insureds were better placed to know which facts they needed to calculate the risk.

In practice... it is more often the case that the underwriter (who will normally have considerable experience of underwriting risks of that particular type) is best placed to determine what information is required for the purposes of assessing the risk. Most underwriters deal with the same types of risk on a day to day basis, whereas the business insured renews their insurance cover once a year. [K&L Gates]

- 3.11 One broker, responding in his personal capacity, pointed out that the majority of businesses are small businesses.

The directors of those businesses have no more knowledge of insurance than consumers. Some will deal direct with insurers, others via a broker but increasingly on a 'non-advised basis' and the rest with a provincial broker into the provincial insurance market.

His concern was that a large business wanting to insure a specialised London Market risk would easily be able to negotiate a waiver for 'innocent non-disclosure' but that those insuring small commercial risks need more protection than the proposed regime would give them.

¹ The remaining 4 consultees commented on the proposal but neither agreed nor disagreed with it.

Overview of responses

- 3.12 The majority of consultees concluded that the duty of disclosure should be retained for business insurance. Some of those that did so admitted that this could lead to harsh results for unsophisticated businesses but felt that this would be mitigated by the provisions below which relate to the test for materiality and which protect honest and reasonable businesses.

THE TEST FOR MATERIALITY

- 3.13 Under current law, an insurer can avoid a contract for misrepresentation or non-disclosure if the misrepresentation induced the insurer to enter into the contract and if it was material. Materiality is defined in sections 18 and 20 of the Marine Insurance Act 1906 as meaning that the representation would

influence the judgment of a prudent insurer in fixing the premium or determining whether he will take the risk.

- 3.14 In the Consultation Paper, we argued that determining whether a representation was material according to the standard of a prudent insurer could be unfair. As the Law Commission said in 1980; “an honest and reasonable insured... may have great difficulty in forming any view as to what facts a prudent underwriter would consider material”.² If, for example, a business is not asked about previous damage, it may honestly and reasonably believe that the insurer is not interested in the occasion when a window was smashed on a Saturday night but no break-in took place. This would especially be the case for minor damage of a kind which would not be covered by the policy in any event. Prudent insurers, however, may well be interested in such matters and the policyholder could find its claim for a burglary or criminal damage (or anything else) refused as a result.
- 3.15 We therefore proposed replacing the prudent insurer test with a ‘reasonable insured’ test. Materiality would then depend on what a reasonable insured in the circumstances would think was relevant to the insurer. We felt that this would be a flexible test and would adapt to the many different circumstances in which insurance is used and sold to a variety of policyholders. In particular it would take into account the knowledge not only of the insured but also of its professional advisers such as the broker. This would form part of the default regime out of which the parties are free to contract (12.31).
- 3.16 Sixty consultees responded to this question. Thirty-one (52%) agreed with the proposal and twenty-nine disagreed. Many consultees welcomed the proposed reform, saying that it would be flexible and fair in the business context. However, those who disagreed were concerned about the standard expected and about uncertainty.

Arguments against the reasonable insured test

- 3.17 The ABI and Fortis Insurance Limited concluded that the reasonable insured test could not be applied in the business context because it was too uncertain:

² Insurance Law, Non-Disclosure and Breach of Warranty, Law Com No 104.

what underwriters think is material may be determined by expert evidence. In the absence of any recognised “reasonable insured” standard, judges are likely to substitute their own version of what they think a reasonable insured would do. This would be even more arbitrary in the context of business insurance, which includes specialist markets, as the judges have to put themselves in the shoes of a reasonable business rather than a reasonable consumer. [ABI and Fortis Insurance Limited]

- 3.18 Some argued that business insurance is a more complex area where there is a diverse range of risks and it would be difficult to create a unitary concept of the reasonable insured. NFU Mutual, for example, are concerned that there will no longer be a single test, as the reasonable insured test will change according to the particular policyholder.

It is envisaged that the characteristics of the ‘prudent insured’ will change from one business to the next, according to, in particular: (i) the nature and size of the business; and (ii) whether or not a broker was used in the transaction. There is no single test, obtaining expert evidence will be almost impossible and the net result will be to give the trial judge a very wide discretion in each case. [NFU Mutual]

- 3.19 The Liverpool Underwriters & Marine Association agreed. They felt that the test would lead to insurers having to provide what would be, in effect, proposal forms, for all types of business in order to be sure that the insured knew which matters it would hold relevant. They felt that this might be possible for some classes of business insurance such as combined commercial³ but that it would be impossible for more specialist forms of insurance such as “aviation, marine, transit, satellite and energy”.

Support for the reasonable insured test

- 3.20 By contrast, some insurers and brokers took the contrary view and felt that a reasonable insured test would improve certainty. It would encourage insurers to be more open about what they consider to be material information. Marsh and Guy Carpenter said that the reasonable insured test would avoid the current practice of ‘information overload’.

Our colleagues have commented that, at present it is very difficult to obtain a clear statement from underwriters as to whether they regard a particular type of information as material. The net effect is that brokers are having to ask their clients to provide ever-increasing amounts of information because they cannot confirm to their clients that certain information is not material to the underwriter. [Marsh and Guy Carpenter]

- 3.21 Others, many of whom felt that the Law Commissions had been wrong to allow a duty to volunteer material information to continue for businesses, felt that this was an important provision. It would mean that policyholders and insurers would work together to ensure that the contract was properly underwritten. One broker wrote

³ A single insurance policy to provide cover for all aspects of a businesses’ risk.

There are still instances where insurers use the present law of non-disclosure and its remedy after the event as a means to avoid what turns out to have been a bad bargain.

3.22 Some saw the flexibility of the reasonable insured test as an advantage. It would adapt itself to the circumstances of the policyholder. Sophisticated large buyers of insurance would be expected either to know through experience or to take advice on the reasonable standard of disclosure, and that standard would be high. At the sophisticated end of the market we expected there to be no difference between the old prudent insurer test and the new reasonable insured test.

3.23 AIRMIC also agreed with this proposal and appreciated that the standard of disclosure expected of their members would be high.

AIRMIC members might be prejudiced by this rule, as being an insurance expert in a company would mean that the definition of 'reasonable' would be strict and as such more evidence would need to be produced to show that all reasonable endeavour was used to ascertain information for the underwriter. [AIRMIC]

The specific test

3.24 In the Consultation Paper, we provisionally proposed that, in order to be entitled to a remedy for the insured's non-disclosure or misrepresentation, the insurer must show that:

- (1) had it known the fact in question it would not have entered into the same contract on the same terms or at all; and
- (2) it must also show either:
 - (a) that a reasonable insured in the circumstances would have appreciated that the fact in question would be one that the insurer would want to know about; *or*
 - (b) that the proposer actually knew that the fact was one that the insurer would want to know about (12.32).

3.25 The first limb of the test is the same as the current law. The insurer must prove that it was induced into the contract by the non-disclosure or the misrepresentation. The second limb is new and reflects the principle set out above, that the standard of materiality should be assessed according to the standard of the reasonable insured. The two sub-limbs (a) and (b) are alternatives. Several consultees misunderstood this and thought that they were cumulative. An insurer has the choice of showing that either a reasonable insured would have known that the insurer wanted to know a fact or that the particular insured knew the insurer wanted to know that fact. If an insurer asked an unusual question, the policyholder could not argue that there was no misrepresentation because the hypothetical reasonable insured would not have thought the information was relevant. It would be enough to show that the particular insured considered it relevant.

- 3.26 Many people responded to this proposal together with the one above. Forty-seven responded to it separately and, of those, thirty-one (66%) agreed with the test. Most made the same points as have been listed above about the change from a prudent insurer test to a reasonable insured test.

Overview of responses

- 3.27 Support for the reasonable insured test was evenly divided. Many welcomed it. They felt that a test of what the 'reasonable insured in the circumstances would think was relevant' would give extra protection to unsophisticated businesses whilst not changing the way sophisticated businesses and insurers currently do business.
- 3.28 However, the lack of a bright-line standard worried some insurers who felt that they would not find it easy to know what standard of disclosure any particular policyholder should reach.

FACTS THE INSURED KNEW OR OUGHT TO HAVE KNOWN

- 3.29 Section 18(1) of the Marine Insurance Act 1909 reads:

...the assured is deemed to know every circumstance which, in the ordinary course of business, ought to be known by him.

In the Consultation Paper we proposed to simplify the test in section 18(1) by limiting the duty of disclosure to facts which the business insured actually knew or which it ought to have known (12.27).

- 3.30 We made this proposal because we wanted the law to distinguish between 'deliberate or reckless' behaviour and 'negligent' behaviour, so that an insurer has an automatic right to avoid only where the insured has behaved in a way that is not honest. Our new proposed test asks whether a business knew the truth and if so whether it failed to disclose or misrepresented that truth deliberately or recklessly, or negligently.
- 3.31 We were concerned that section 18(1) would prevent these new tests from being implemented properly. On a technical reading, section 18(1) could have the effect of deeming knowledge, which would mean that all non-disclosures and misrepresentations would be fraudulent. It would not be possible to find that a business acted honestly and reasonably or negligently.
- 3.32 Fifty respondents gave their view on this proposal and forty-five (90%) agreed with it.
- 3.33 A few warned against changing the law if, as they believe, the courts deal well with the current test. The Lloyd's Market Association were unconvinced that there was a problem with the existing form of words. Swiss Re regarded it as a matter of language simplification.

This will remove the problem of being deemed to know ‘every circumstance which in the ordinary course of business ought to be known by him’ which is a somewhat unwieldy test. But the ‘ought to have known’ limb could well bring its own difficulties in interpretation and in assessment of the insured’s business and organisation. [Swiss Re]

The burden of proof

3.34 In our Consultation Paper we proposed that, in cases of non-disclosure and misrepresentation, the insurer should carry the burden of proving that a business insured should have known a particular fact (12.28).

3.35 Forty-eight consultees responded to this proposal and thirty-eight (79%) agreed that the burden of proof should be on the insurer. However, only three of those respondents gave a reasoned agreement. They all felt that it is the correct approach to place the onus on the party who is seeking to avoid the contract. As the British Insurance Law Association (BILA) wrote,

[this] is consistent with the general rule in English law: he who alleges must prove. [BILA]

3.36 The other ten consultees felt that the onus should be on the insured. Half of those were insurers who all felt it would be difficult for an insurer to prove that a business should have known a particular fact. One insurer pointed out that the insurer is not an expert in the insured’s business and therefore will find it difficult to show what the business insured should have known. The Royal Bank of Scotland wrote:

we do not agree that the burden of proof should rest with the insurer, or understand how an insurer will be in a position to prove this. The insured is better positioned to present an argument for why it did not know, or there was no reason for it to have known, the facts in question. We believe that burden should rest with the insured in line with the Misrepresentation Act 1967. [The Royal Bank of Scotland]

Overview of responses

3.37 The majority of consultees agreed with the principle that a business insured is only responsible for disclosing facts which it knew or ought to have known and were happy for section 18(1) to be amended, if necessary, to achieve this. Several consultees, whilst agreeing with the principle, felt that the courts were already able to interpret section 18(1) to reach the result we were seeking. The majority also agreed that the burden of proof that a business should have known a particular fact should be on the insurer.

MISREPRESENTATIONS

3.38 One of the general principles underlying our proposed reforms was that an insured who was both honest and careful in giving pre-contractual information should not have a claim turned down on the basis that the information was incorrect or incomplete. In our Consultation Paper we provisionally proposed that this principle should apply to business insurance.

3.39 In order to implement this we made the following proposals:

(1) that when a business makes a misrepresentation but it honestly and reasonably believed what it said to be true, the insurer should not be able to refuse to pay any claim or avoid the policy, unless the parties agreed otherwise (12.29);

and

(2) that the burden of showing that the insured did not have reasonable grounds for believing that what it said was true should be on the insurer (12.30).

Honest and reasonable

3.40 In the Consultation Paper, we said that where a business proposer has made a misrepresentation, but the proposer honestly and reasonably believed it to be true, the insurer should not be able to refuse to pay any claim or avoid the policy, unless the parties have agreed otherwise (12.29). This proposal would bring the law into line with good market practice.

3.41 Fifty consultees responded to this proposal. Thirty (60%) agreed with the proposal, and the majority of those agreed without any reasoning or reservation. The fifteen who disagreed did so for differing reasons.⁴

3.42 Some had reservations about compelling an insurer to bear the consequences of honest and reasonable misrepresentations. The International Underwriting Association of London argued:

it is difficult to rationalise why an insurer should be forced to accept a risk or pay a claim on a risk that they would not have written if they had had full knowledge of the facts. Though there are relatively few circumstances where an innocent mistake would lead to this outcome, the fact remains that the insured is at fault and, given the sophistication of the insured and how risks are placed, it would be inequitable to hold the insurer on risk for such failings, especially where they have asked clear and comprehensive questions and could have done no more in terms of assessing the risk. [International Underwriting Association of London]

3.43 The British Insurance Law Association argued that a proportionate remedy would be better in cases of honest and reasonable misrepresentation, so that the insurer and the policyholder share the burden of the mistake.

⁴ Five further consultees made comments on the proposal without indicating whether they agreed or disagreed with it.

While we can see force, in consumer insurance, of not penalising an honest and careful insured, in business insurance the considerations are different. We accordingly believe that some remedy should be retained by the insurer. This need not be the draconian “all or nothing” remedy of avoidance. It is therefore for consideration whether a proportional remedy should be introduced for innocent misrepresentation. [British Insurance Law Association]

3.44 Lloyd’s agreed, writing:

we do not think that the underlying (default position) law should entail the risk transfer to the insurer of the facts turning out to be different from those facts supposed by the insured and the insurer, on the basis of which the insurer (mistakenly) wrote the contract, and determined the applicable terms and premium. There may, however, where the misrepresentation is entirely innocent, be a case for introducing a “proportionate” remedy. [Lloyd’s]

3.45 Some disagreed with the proposal because it was not mandatory. They felt that the principle that honest and reasonable policyholders should have their claims paid was so important that it should not be possible for the parties to contract out of it. Professor John Birds, for example, said:

I am not convinced of the desirability of providing for contracting out, certainly as far as smaller businesses are concerned. [John Birds]

3.46 Lord Justice Rix was also in favour of making the reform mandatory but reached a different conclusion on what the reform should be. He argued that insurers should not in general be permitted to avoid for honest and reasonable misrepresentations. However, where the honest and reasonable misrepresentation is relevant to the loss suffered, he felt that the insurer should be able to refuse to pay the claim.

I agree that the insurer should not be able to avoid the policy: but perhaps he should be able to refuse the claim, where the innocent misrepresentation is relevant to it? And if he can refuse the claim in such a case, I am not sure I would permit him to reserve the right by contract to avoid the policy for innocent misrepresentation. [Lord Justice Rix]

The burden of proof

3.47 We proposed that the burden of showing that the insured did not have reasonable grounds for believing that what it said was true should be on the insurer (12.30).

3.48 Forty-eight respondents gave their views on this question and thirty-one (65%) agreed. The arguments raised were similar to those raised (at paragraph 3.34 above) in response to the burden of proving that the insured knew or ought to have known a particular fact. The majority of the respondents agreed with this proposal without any reasoning or reservations. Those that disagreed felt that the burden would be difficult for an insurer, as all the evidence would be held by the insured.

NON-DISCLOSURE AND MISREPRESENTATION - REMEDIES

3.49 Above we have discussed the basic principles for reform of the law of non-disclosure and misrepresentation. We now consider the consequences of misrepresentation and non-disclosure.

Should the law distinguish between dishonest and negligent conduct?

3.50 In the Consultation Paper, we suggested that the consequence for non-disclosure or misrepresentation should depend on the policyholder's state of mind. The categories we put forward were;

- (1) 'innocent' where the insured was honest and reasonable, as discussed above. Here the insured should be protected and claims should be paid;
- (2) 'negligent' where the insured did not show the degree of care required.
- (3) 'deliberate or reckless' involving a degree of dishonesty by the insured. Here the insurer should be entitled to avoid the policy.

3.51 In our paper we asked what the result should be where the policyholder was negligent. For negligent conduct, should the law provide a remedy which (unless the parties have agreed otherwise) aims to put the insurer into the position in which it would have been had it known the true circumstances (12.33)?

3.52 In our Consultation Paper we explained that the way a proportionate settlement would work for businesses is that the court would first ask what the insurer would have done had it been aware of the true position:

- (1) where an insurer would have excluded a particular type of claim, the insurer should not be obliged to pay claims that would fall within the exclusion;
- (2) where an insurer would have required precautions to be taken (for example in the form of a warranty) or would have imposed an excess, the policy would be treated as if it contained those terms;
- (3) where an insurer would have declined the risk altogether, the policy would be avoided and the claim may be refused;
- (4) where an insurer would have charged more, the claim should be reduced proportionately to the under-payment of premium.

3.53 In the Consultation Paper we suggested that the insurer would be overcompensated if it were able to avoid a contract and refuse to pay a claim in the case of negligent conduct. Therefore, we asked consultees if a proportionate remedy would be more appropriate for negligent behaviour.

3.54 The alternative would be to make no distinction between negligent and deliberate or reckless conduct, with the same remedy of avoidance for both. This would have the advantage of being straightforward. We could see two further advantages. First, it might be difficult to prove that a business insured acted dishonestly. Secondly, we thought that there was an argument for creating a strong incentive for business insureds to act carefully.

- 3.55 The Commissions asked a question about this issue, indicating that they had not reached a preliminary view, and were seeking opinions from the market.

Support for a proportionate remedy for negligent conduct

- 3.56 Sixty-one respondents gave their views on this question. Of those, thirty-six (59%) argued that the law on business insurance should distinguish between dishonest and negligent conduct and that a compensatory remedy should apply in cases of negligent behaviour.

- 3.57 K&L Gates LLP argued;

the suggestion that there should be "strong incentives" to encourage businesses to act carefully applies equally to insurers, i.e. there should be strong incentives on insurers to ask the right questions of insureds to ensure that they extract the right information required to enable them to properly assess the risk. Also, the fact that for "non-standard" risks it may be difficult to show what an insurer would have done had they known the true facts is not sufficient reason to retain the avoidance remedy. [K&L Gates]

- 3.58 Some insurers also agreed that a proportionate remedy would be a better solution. Bright Grey, Aviva plc and Allianz Insurance plc, for example, all wrote in favour of applying a compensatory remedy to cases of negligent behaviour. They argued that where there has been negligent conduct on the part of the insured the insurer should be put in the same position in which it would have been had it known the true circumstances.

Support for avoidance for negligent conduct

- 3.59 Twenty consultees (33%) argued that there should not be a distinction between negligent and dishonest conduct in business insurance. They believed the remedy of avoidance should continue to apply in cases of negligent behaviour.

- 3.60 Some argued that negligent conduct should be penalised as it constitutes a moral hazard. For instance, BILA argued:

carelessness on the part of an insured is a "moral hazard" which ought to be penalised. A by-product of this is that reasonable conduct on the part of the insured will be incentivised. [BILA]

- 3.61 Others felt that it would be acceptable for insureds' negligent behaviour to be treated the same way as dishonest behaviour because it is difficult for insurers to prove that businesses have been dishonest. It is difficult to pin down who knew what at which stage and to find out what the controlling mind of the organisation thought.

3.62 Many saw practical problems with applying a proportionate remedy for business insurance. Policies are more likely to be bespoke and evidence will not necessarily be available to show how insurers would have acted if they had known the true facts. Negligent conduct, they argued, should be treated in the same way as dishonest conduct because it is far more likely that businesses will have received professional advice. Some also felt that whilst businesses would be prepared to pay an increase in premiums to have a claim paid despite honest and reasonable misrepresentations, they would not be so willing for their premiums to increase to cover the negligent mistakes of their competitors.

Presumptions

3.63 In our Consultation Paper we anticipated some of the arguments against applying a proportionate response for negligent conduct. We therefore asked whether three points would assist insurers and policyholders when applying a proportionate remedy (12.34). The questions we asked were:

- (1) should there be a rebuttable presumption that the insured knew any fact that in the ordinary course of business it ought to have known?
- (2) do respondents agree that, where the insurer would have declined the risk, the insurer should be entitled to avoid the policy, and the court should have no discretion to apply a proportionate solution?
- (3) do respondents agree that negligent misrepresentation or non-disclosure should be a ground on which the insurer may cancel the policy after reasonable notice, without prejudice to claims that have arisen or arise within the notice period?

A rebuttable presumption

3.64 Forty-five consultees gave their views on this question and forty (89%) of them agreed that there should be a rebuttable presumption that the insured knew any fact that in the ordinary course of business it ought to have known. They agreed with us that, in view of the difficulties of proving corporate knowledge, this would be an appropriate safeguard.

The insurer should be entitled to avoid the policy if it would have declined the risk

3.65 Forty-eight consultees gave their views on whether, if the insurer would have declined the risk, the insurer should be entitled to avoid the policy and the court should have no discretion to apply a proportionate solution. Thirty-one (65%) agreed with the proposal. The disadvantage, however, is that the policyholder would suffer if that particular insurer would have refused to accept the risk but others in the market would not have done.

3.66 The Chamber of Shipping claimed that under this proposal it would be too easy for an insurer immediately to argue that it would not have accepted the risk.

There should, instead, be a presumption that the risk would have been written with the insurer required to show why it would not have been accepted or the alternative terms which would have been applied. Where this is shown to be the case, any prejudice suffered by the insurer could be compensated by an appropriate adjustment to the claim. [Chamber of Shipping]

The insurer may cancel the policy for the future after a negligent misrepresentation or non-disclosure after a reasonable period of notice

- 3.67 This proposal was designed to ensure that insurers could cancel policies for the future after a reasonable period of notice when the policyholder made a negligent misrepresentation or non-disclosure. Cancellation would be without prejudice to any claims which had arisen or which arose within the notice period. Forty-seven consultees gave their views on this question and thirty-one (66%) of them agreed with this proposal. Two of those respondents agreed subject to adopting an appropriate definition of “reasonable notice”. Peter Franklin, a broker, said that at least a month would be needed to replace even simple risks.
- 3.68 Those who disagreed with this proposal felt that it would be better for insurers to be able to terminate the policy immediately. The Liverpool Underwriters & Marine Association said that underwriters should be able to give notice of termination with immediate effect, as their experience has shown that advance notice of cancellation prompts claims.

Overview of responses

- 3.69 The majority of consultees welcomed drawing a distinction between negligent and dishonest conduct. Others, however, saw practical problems involved in providing a proportionate remedy, even if the three points listed above were included within any new statute. Finally, some saw it as providing too much protection for businesses. In the overall package of reform, they felt that changing the prudent insurer test and also allowing a negligent insured to have some of its claims paid was a step too far.

WARRANTIES OF PAST OR PRESENT FACT

- 3.70 Insurers often ask business insureds to give warranties of past or present fact. In our Consultation Paper we identified two problems with this. First, if the insurer obtains a warranty from the insured as to a past or present fact, and the fact stated is not true, the insurer may treat the policy as discharged. This applies even if the insurer did not rely on the statement and if the insured honestly and reasonably believed that what they said was correct. Secondly, every statement of fact by the proposer can be converted into a warranty by a basis of the contract clause contained only in the proposal form.
- 3.71 In this part of our paper we discuss the responses we received to our proposals for reform of the law relating to warranties of past and present fact. We start with basis of the contract clauses and then move on to warranties in general.

Basis of the contract clauses

- 3.72 In the Consultation Paper, we argued that basis of the contract clauses should not be permitted in business contracts of insurance. We proposed that the law should not give any effect to a term on a proposal form or elsewhere which converts answers into warranties en bloc (12.35).
- 3.73 Fifty-four consultees gave their views on this question and forty-two (78%) of them agreed with the proposal.
- 3.74 Leeds Marine Insurance Association agreed that such clauses should be abolished, as they “have the effect of making all the clauses equally important”.
- 3.75 A few respondents were concerned about this proposal. The ABI, for example, felt that primary legislation was not the appropriate vehicle for dealing with such clauses. Brit Insurance Holdings PLC raised concerns that such a proposal would extend greatly the lists of warranties in policies making the documents cumbersome.
- 3.76 The Royal Bank of Scotland did not think the proposal was appropriate for businesses that are free to negotiate their own contracts and that seek expert advice. They argued, therefore, that the clauses should not be abolished. They sympathised with small and medium sized enterprises but did not feel that the law should be changed to support them.

We have some sympathy for smaller ‘consumer type’ businesses, which are encouraged down the e-commerce or direct route and insurers must do more to support, and better inform, these businesses. Although we do not support a change in the law to achieve this, it remains a matter of good insurance practice and accords with the FSA’s principle of treating customers fairly. Contract certainty is paramount and has already moved the industry in this direction. [The Royal Bank of Scotland]

Strict liability for breach of warranty

- 3.77 For consumer insurance we proposed that warranties should be treated as if they were representations so that the insurer would have to establish inducement, materiality and that the consumer was acting deliberately or recklessly to be able to refuse to pay the claim. We did not think, however, that such proposals would be appropriate for business insurance.
- 3.78 In the Consultation Paper, we proposed that businesses’ liability for breach of a warranty of fact should remain strict but, unless the contract provides otherwise, the insurer should not be able to rely on the breach of warranty:
- (1) if it was not material to the contract; or
 - (2) as a defence to a claim for a loss that was in no way connected to the breach of warranty (12.37).
- 3.79 Forty-one consultees gave their views on this question and thirty (73%) agreed with it, including several insurers.

- 3.80 Seven consultees (17%) disagreed with the proposal in principle. Clyde & Co, for example, reported that the attendees at a seminar it organised felt that it was important for insurers to be able to use warranties of fact and to be able to rely on them, especially if basis of the contract clauses are to be abolished. They do not feel that a causal connection test is appropriate in business insurance. The ABI too questioned whether a causal connection test was appropriate and two insurers felt that it would lead to an increase in moral hazard as policyholders would breach warranties more freely and take a gamble that they would still be paid for unconnected losses.

Overview of responses

- 3.81 The majority of consultees supported our proposals for business warranties. They felt that basis of the contract clauses should be abolished and that a causal connection test should be used. Some insurers said that this already reflected their practice. However there were areas that gave rise to concern, such as the definition of “material” and how a causal connection test would work in practice. We discuss consultees’ general comments on causal connection tests in practice at greater length in the context of warranties of future conduct at paragraph 4.7 below.

THE DEFAULT REGIME AND CONTRACTING OUT

- 3.82 The proposals for non-disclosure, misrepresentation and breach of warranty above would, with the exception of one proposal,⁵ form a default regime for business insurance contracts. This means that the parties would be free to agree other terms and stricter consequences if they wished. Our view was that the parties should be free to agree that, in the event of a particular fact being untrue, the insurer can avoid the contract or refuse to pay any claims, but this must be done explicitly. We therefore made proposals dealing with contracting out in general. We also looked at those policyholders who contract on insurers’ standard terms of business without negotiation and suggested extra protection for these businesses. We discuss contracting out and then standard terms below.

Contracting out

- 3.83 We proposed that the parties should be free to contract out of the default regime in two ways. The policy or accompanying document could contain a written term that:
- (1) The insurer would have one or more specified remedies for misrepresentation even if the proposer was neither dishonest nor careless in giving the information; or
 - (2) The proposer warrants that specified statements are correct (12.36).

⁵ The one proposal which it would be impossible for businesses to contract out of would be the one that abolishes basis of the contract clauses. The rule which states that the law should not give any effect to a term on a proposal form which converts answers into warranties en bloc (12.35) would need to be mandatory, otherwise the mere insertion of a ‘basis of the contract clause’ might be taken as contracting out and the new rule would be nugatory.

- 3.84 Sixty-two consultees gave their views on this proposal and thirty-eight (61%) agreed with it. Some welcomed the freedom to contract out, feeling that this would enable them to return to the position under the Marine Insurance Act 1906, with which they felt more comfortable. The Leeds Marine Insurance Association said that, if a new regime is adopted, then contracting out should be possible to reverse its effects because, “the system works perfectly well currently and should be maintained in the interests of free trade”.
- 3.85 The ABI and Fortis Insurance Limited agreed, and wondered, if contracting out was possible, on what basis the proposals for change are necessary or justified? Our intention was that the written contracting-out clause or agreement would alert the policyholder to the fact that certain specified remedies would be imposed when it made mistakes when providing information, no matter how honest or reasonable those mistakes. AIRMIC supported the proposal for this reason, saying that “safeguards should be in place to ensure that the insured is made explicitly aware that the contract is not subject to the default regime”.
- 3.86 Thirteen respondents (21%) argued the opposite position. They felt that allowing the parties to contract out would render the reforms less powerful. They felt that it was wrong to assume that even relatively sophisticated businesses would have the bargaining power to re-negotiate a contract along the lines of the reforms with an insurer.
- 3.87 Others focused their comments on the practicalities of the reform. Marsh and Guy Carpenter wrote:

we consider that the new regime should be mandatory for all insureds, with no right to contract out. The alternative would be a multiplicity of regimes. Our brokers have commented that, in a subscription market it would be very difficult for insureds to understand the implications of some insurers operating within the default regime and others not. The ability to contract out could also create difficulties when comparing quotations from different insurers.
[Marsh and Guy Carpenter]

Lying behind their comment is the fact that a broker’s client’s choice of an insurance policy would not then always be made on price. Other factors would have to be taken into consideration, such as whether the insured was willing to pay extra to protect it from its own honest mistakes or carelessness.

- 3.88 Professor Robert Merkin disagreed with allowing the parties to contract out in principle and warned that the proposed test would create further difficulties. He wrote “the test for the validity of a contracting out provision simply creates an additional layer of dispute”.
- 3.89 Munich Re UK Life Branch made a general comment in relation to this proposal from a reinsurance perspective. It said,

we remain to be convinced that the default for reinsurance should be the suggested regime for business insurance rather than the existing Marine Insurance Act. However, for normal business to business (or if reinsurance *should* default to this), we agree that the parties should be free to contract out in the above circumstances... The parties should have a general right to contract out, *unless* the Act specifically restricts this freedom. We feel this is vital to ensure freedom of contract and the required level of flexibility, especially at the reinsurance level. [Munich Re UK Life Branch]

Extra safeguards when contracting out

3.90 In the Consultation Paper we argued that it was necessary to provide extra protection for businesses which are not insurance experts when they contract on standard terms. We were concerned that these businesses would have less protection when they bought an off-the-shelf product, on terms which the insurer has already devised. We felt that safeguards were necessary to prevent insurers from routinely contracting out of the default regime in such contracts without explaining the implications to the policyholder.

3.91 Our provisional proposal states that special controls should apply where:

- (1) the insured contracts on the insurer's written standard terms of business;
and
- (2) one such term purports to give the insurer greater rights than the default regime would allow to refuse claims on the basis of the insured's failure to provide accurate pre-contract information; *and*
- (3) that term defeats the insured's reasonable expectations (12.38 and 12.39).

3.92 If all three limbs of the test are satisfied, the insurer would be unable to rely on the term. These controls would not try to address the case in which the insured understands the terms but lacks the bargaining power to obtain a more favourable term. Instead it addresses only whether a particular term meets the policyholder's reasonable expectations. By questioning whether the term defeats reasonable expectations we were asking whether the term had been properly brought to the policyholder's attention, not whether the term itself was reasonable.

3.93 Below we discuss limbs 1 and 2 together, before looking at limb 3.

Limbs 1 and 2: the insurer's standard terms

3.94 Limbs 1 and 2 specify that special controls will apply only if the insured contracts on the insurer's set of standard terms of business and if one of those terms purports to give the insurer greater rights than the default regime. The concept of 'standard terms' was intended to identify mass-market insurance products where the policyholder might need more protection. Fifty-three consultees gave their views on this and fifteen (28%) of them agreed with the proposed tests.

- 3.95 Most consultees concentrated on the practical difficulties which the standard terms test would create. Many were unsure how a standard terms contract would be defined in the insurance market, as most contracts of insurance consist predominantly of tried-and-tested terms. It would be impossible for an insurer to write a contract that did not include a large proportion of these standard terms and even if it were amended or negotiated, the clauses added as a result would also normally be standard term endorsements. They wondered therefore where the dividing line between standard term and non-standard term contracts would fall in practice. Consultees also felt that when a new contract is developed it might be a non-standard contract, but wondered how many times it would need to be reused before it became a standard term contract.
- 3.96 AIRMIC, for example, agreed with the proposal but, like most others, sought further details on how to recognise an insurance contract written on 'standard terms'. They raised the issue of the broker's standard wording:
- There will also be a problem when the insured contracts on the brokers' standard wording, which is underwritten by the insurer. Would this mean that they are on non-standard as they are not the insurers own, or would they be classed as standard as the insurer has accepted them as being issued on their behalf. [AIRMIC]
- 3.97 The Lloyd's Market Association said that standard terms of business are not a defined concept in the Lloyd's and London subscription market and, therefore, this proposal would create difficulties. The market commonly uses recognised and approved wordings, but various combinations of those are used to form bespoke contracts for most Lloyd's business, meaning that a typical Lloyd's and London subscription market contract would be likely to satisfy any definition of standard terms.
- 3.98 In summary most felt that the test itself would create too many complications and could therefore have an impact on the price of cover. The Commercial Court Users Committee, for example, summarised the position as follows:
- The imposition of statutory controls would give rise to considerable uncertainty for insurers, especially if market wordings (which are often designed by or with the input of brokers) are incorporated into insurance contracts. It may be many years before such standard terms aimed at contracting out of the default regime are tested in the Courts to establish whether they are effective. [Commercial Court Users' Committee]
- 3.99 It is therefore clear that consultees consider that the use of standard terms is not a straightforward way of identifying contracts signed by unsophisticated businesses.
- 3.100 It is difficult to analyse the numbers who agreed with the principle which lay behind the proposal; that is, that controls should be placed on contracting out to protect less sophisticated businesses. Several consultees indicated that they were not in favour of the test because as a matter of practicality it would not work, rather than because it was not the right thing to do in principle. Others did separate the practical problems from the principle.

Limb 3: reasonable expectations

- 3.101 The third limb of the test asked whether the contracting out term “defeated the insured’s reasonable expectations”. The phrase ‘reasonable expectations’ was misunderstood by many consultees. They assumed that it asked whether the substance of the term was reasonable and concluded that it was a fairness test of the substance of the term. This is not what we intended. By asking whether a term met a policyholder’s reasonable expectations, we meant the following; has that term and its consequences been properly brought to the policyholder’s attention? The idea was that it would catch situations where, for example, a clause was put into the small-print of a contract with a small business saying that the consequence of all misrepresentations was avoidance, no matter whether they were material or honest.
- 3.102 We therefore provisionally proposed that the insurer should not be permitted to rely on such a term if it was not what the insured expected and would therefore not meet its reasonable expectations. (12.39)
- 3.103 Fifty-one consultees gave their views on this question. Twenty-four (47%) agreed with it.
- 3.104 Some felt that a new reasonable expectations test was a step too far and the position could be covered by normal contractual principles or the treating customers fairly principle. Clyde & Co reported the following argument made at a seminar:
- the term “reasonable expectations” introduces a new and undesirable element of uncertainty, even if it is only a procedural safeguard. The matter can be adequately addressed by the English rules on incorporation of contract terms. [Clyde & Co]
- 3.105 Friends Provident said that they are already duty-bound by obligations such as treating customers fairly, and this obligation is therefore already factored into the production of all documentation. Others agreed that extra legislation would simply confuse the position.

Overview of responses

- 3.106 Consultees have reservations about the proposed tests for identifying and giving more protection to policyholders who buy off-the-shelf products without much specialist knowledge of insurance. ‘Reasonable expectations’ and ‘standard term insurance contracts’ were concepts criticised by many. Despite this, support for the proposals was fairly evenly balanced, suggesting that a number of consultees felt that there was a case for affording more protection to businesses who do not have the negotiating power to insist on the default regime, even if they disagreed with the specific tests we proposed.

SMALL BUSINESSES

- 3.107 In our Consultation Paper, we discussed the problems of the unsophisticated business insured. As Lord Justice Longmore put it

How can it be right that a lawyer insuring his home and household possessions can rely on the more relaxed test of non-disclosure under the Statements of Practice, but the small trader, e.g. the garage owner or the fishmonger insuring his premises, cannot?⁶ [Lord Justice Longmore]

- 3.108 We therefore asked whether extra protection was necessary for small businesses (in addition to the regime set out above), and if so, how it would be possible to define them (12.43).
- 3.109 Fifty-seven consultees gave their views on this question and fifteen of them (26%) thought that there was a need to protect smaller businesses further than the default regime. Many of those felt that those small businesses should be treated as consumers.
- 3.110 The Financial Ombudsman Service (FOS) already has jurisdiction to hear small business cases. When it hears a small business case it assesses the sophistication of the business in question. It treats the most vulnerable businesses as consumers and applies the consumer standards to their disclosures, whilst others are held to the higher business standards as set out under the Marine Insurance Act 1906. In its response to us, the FOS argued that small businesses were in need of greater protection.

the law should offer some greater protection to those that are known, or it is reasonably apparent were, unsophisticated buyers of insurance without access to expert intermediary advice. [FOS]

- 3.111 Endsleigh argued that the protections extended to consumers should be extended to small businesses. They said,

some small businesses are so similar to consumers that they should not be expected to volunteer information and, in our view, there is no justification for a greater expectation of knowledge in terms of disclosure requirements. [Endsleigh]

- 3.112 A few believe that protection should be available to small businesses based on a set criterion of the size of the business. For instance, the Liverpool Underwriters & Marine Association argued that,

small businesses should benefit from the consumer proposals... but on the basis that the number of employees, earnings and assets should be reduced substantially, although some high risk value business, such as hauliers liability, should not have the benefit of the consumer protections. [Liverpool Underwriters & Marine Association]

- 3.113 However, the majority argued that, if the default regime were implemented, small businesses would not need any further protection. They would have the benefit of the “reasonable insured” test, which will adapt itself to the circumstance of the policyholder as well as controls on the insurer’s ability to contract out of the default regime.

⁶ “An insurance contract act for a new century?”, Pat Saxton Memorial Lecture, 5 March

Overview of responses

- 3.114 The majority of consultees felt that there was no need for any extra protection for small businesses. They were well enough protected by the proposed default regime. However, a significant minority thought that in all cases the smallest businesses should be treated as consumers, and should not be subject to the business regime at all.

MARINE, AVIATION AND TRANSPORT INSURANCE

- 3.115 In the Consultation Paper, we provisionally proposed that the proposals outlined above should apply to marine, aviation and transport insurance (MAT)(12.40). This is because we were told that MAT was no longer regarded as a separate and distinct form of insurance and it would be difficult and complex to apply one law to (for example) major construction projects, and quite another to ships.
- 3.116 Forty-one consultees responded to our proposal and thirty-seven (90%) of them agreed that there should not be separate rules for MAT.
- 3.117 Lloyd's, for example, argued that the default regime proposals should only apply to MAT if any new insurance contract Act contained certain well-established marine rules. A major broker and participants in a Clyde & Co seminar said that it would appear sensible to keep the law for business insurance applicable across all sectors. The ABI also agreed with this proposal as they feel that marine, aviation and transport insurance should be treated in the same way as business insurance. However, they remain to be convinced of the need for wide ranging change in the business market at all. If changes are to be made they emphasise that "the right to freedom of contract should be paramount".
- 3.118 It was pointed out to us that in Australia, for example, attempts to exclude marine insurance from the Australian 1984 Insurance Contract Act have led to questions about whether particular forms of insurance fall within or outside the Act. At present, in the UK there is no need for judges to decide whether static oil platforms engage in "navigation of the seas" which is part of the definition of "marine peril". They also do not need to discuss whether inland waters are different from the "sea" under the Marine Insurance Act 1906.⁷ Other questions arise in relation to individuals insuring pleasure boats and whether public liability and employer liability insurance connected with ships would fall within marine insurance.
- 3.119 Five respondents disagreed with this proposal and three of them were insurers. One respondent said that the MAT market is highly specialised and dominated by extremely large commercial risks. Adopting the proposed reforms would be likely to lead to increased costs simply to cover the uncertainties such as the proposal on opting out.
- 3.120 The Liverpool Underwriters & Marine Association argued that there are many differences between marine and non-marine business:

2001 (set out in Appendix A of BILA, Insurance Contract Law Reform 2002), para 42.

⁷ Section 2(1).

marine is usually valued while non marine is unvalued. Marine contains a warranty as to legality for obvious reasons, whilst no similar provision applies in relation to non-marine business. Marine risks 'move' and have multinational involvement. [Liverpool Underwriters & Marine Association]

- 3.121 The International Group of P&I Clubs⁸ said that marine insurance should be subject to different rules, and therefore the business proposals should not apply.

MAT insurance can be distinguished from other forms of commercial insurance by virtue of its specialised nature and the general advanced level of knowledge and commercial sophistication of insured and insurers involved in it... Moreover, a large body of judicial precedent applicable to MAT insurance (in particular in relation to the interpretation of the Marine Insurance Act 1906) has been built up over many years which provides substantial certainty to those engaged in this type of insurance and consequently a reduction in litigation with its associated costs. The Group therefore believes that on balance there is a good case for MAT insurance to be subject to different rules. [International Group of P&I Clubs]

Overview of responses

- 3.122 The majority felt that there should be a single scheme for all forms of business insurance, no matter what the subject matter of the contract. They were concerned about how a distinction between MAT and non-MAT would work in practice.
- 3.123 However, a few consultees (including many of those who worked in the specialised part of the industry) felt that MAT was a special case and as a sophisticated, developed market it should be allowed to continue trading in the way in which it traditionally has.

REINSURANCE

- 3.124 In the Consultation Paper, we provisionally proposed that amendments made to the law for business insurance generally should also apply to reinsurance (12.41).
- 3.125 Fifty-one consultees gave their views on this question and forty-six (90%) of them agreed with the proposal. However, some put forward a strong case for excluding reinsurance from the proposed reforms. They argued that:

- (1) a purchaser of reinsurance is far more sophisticated than the standard business policyholder. In any event, reinsurance contracts are concluded with the assistance of highly skilled reinsurance brokers. Where a reinsured has concerns about its pre-contractual disclosures it can, for example, require an anti-avoidance protection to be built into the contract. It does not need law reform to help it do this.

⁸ A Protection and Indemnity Club.

- (2) contracting out is not a viable solution in practice. This is because it will either require a distillation of the entire legal environment in which reinsurance currently operates into the terms of the contract or a clause excluding the new insurance contracts statute in favour of the Marine Insurance Act 1906. The consultee feels that neither is an attractive position and think that the more likely option will be for reinsurers to select an alternative, such as Bermudan, Singaporean or New York law. The regime of contracting out is further complicated by the proposals on standard terms and reasonable expectations.
- 3.126 However, the vast majority of consultees agreed that, if the law were to be changed, it should be changed for all areas of business, including reinsurance.
- 3.127 A major broker, for example, wrote that there should be no scope for valid reinsurance claims to be rejected (or for reinsurance policies to be avoided, with no right to avoid the original policy) because of differing consequences under reinsurance law as compared to insurance law. The ABI also believed that reinsurance should be treated in the same way as business insurance as reinsurers must be bound by the same set of reforms as those applying to the insurance they are underwriting.

Overview of responses

- 3.128 Most consultees were strongly in favour of including reinsurance within the proposed reforms, for reasons of consistency. However, some, including reinsurers, had concerns about this.

THIRD PARTY CLAIMS

- 3.129 In the Consultation Paper we commented on the problem of third party claims. We discussed whether it was desirable that the rights of a third party should be affected by the acts or omissions of the policyholder. Under the Road Traffic Act 1988, an insurer is obliged to meet third party claims in motor insurance cases, even where a policy has been avoided for misrepresentation or non-disclosure by the policyholder. Where the policyholder is insolvent, the third party can bring a claim directly against the insurer under the Third Parties (Rights Against Insurers) Act 1930. However, defences such as misrepresentation or non-disclosure which are available to the insurer against the policyholder can also be used against a third party.
- 3.130 Although there are arguments in favour of giving third parties Road Traffic Act-style protection, we argued in our Consultation Paper that the relevant statutory scheme or professional bodies would be in the best position to deal with such matters. Therefore, our provisional view was that we should not extend the existing rights of third parties (12.42).
- 3.131 Forty-eight consultees gave their views on this question and forty-one (85%) of them agreed with our proposal.

3.132 The Association of Personal Injury Lawyers, however, felt that the obligation to meet third party claims should extend to insurers selling particular types of insurance (not only just motor insurance). It argued that there is a strong case for giving extra protection in relation to employers' liability insurance. A requirement for employers' liability insurance is imposed by statute, and therefore statute should offer a remedy to those employees who innocently suffer from their employer's misrepresentations. They argued that there is no other professional body which can impose such a requirement on all employers' liability policies and felt therefore that statute should.

Overview of responses

3.133 The vast majority of consultees did not feel that there was justification for extending the Road Traffic Act-style protection to all policies where a third party would benefit.

PART 4

WARRANTIES AS TO THE FUTURE

CONSUMER INSURANCE

- 4.1 In our summary of responses to consumer proposals we concluded that there was not a widespread problem with warranties of future conduct in consumer insurance contracts. Our survey of 50 Financial Ombudsman Service cases did not uncover any cases which were based on warranties of future conduct. We therefore concluded that the proposed reforms would be merely a tidying-up exercise for consumer insurance and would be better discussed at the same time as business insurance, where warranties are more commonly used.
- 4.2 Reform of warranties of future conduct in consumer insurance law is therefore discussed in this paper alongside business insurance, rather than in the consumer summary paper.

INTRODUCTION

- 4.3 We identified two principal criticisms of warranties of future conduct. The first is that a breach of warranty in an insurance contract automatically discharges the insurer from liability, regardless of whether the breach is serious or whether the matter warranted made any difference to the risk. The result is that the law permits insurers to refuse to pay a claim because of actions or omissions which:
- (1) are *immaterial to the risk*. For example, an insurer is permitted to refuse to pay a claim because the insured innocently misstated the location at which a lorry was (or would be) kept, even though this did not increase the risk.¹
 - (2) are *irrelevant to the loss* that has occurred. For example, a failure to employ a watchman may discharge an insurer from liability for a claim for storm damage which, obviously, no watchman could have prevented.
 - (3) have *already been remedied*. For example, if the warranty requires an alarm system to be continuously operational and for some weeks it breaks down, there is no cover even after the alarm has been repaired.
- 4.4 The second problem we identified was that policyholders, especially unsophisticated business policyholders, are often unaware of the existence of warranties and of the consequences of breaching them. Business policies are not covered by the Unfair Terms in Consumer Contracts Regulations 1999 (UTCCR) which protects consumers against unfair terms in insurance contracts. We identified a particular problem with businesses which contract using non-negotiated mass-market contracts.

¹ *Dawsons Ltd v Bonnin* [1922] 2 AC 413, 1922 SC (HL) 156.

- 4.5 We therefore developed proposals in response to these two problems. To deal with the unfair results that can follow from a breach of warranty, we proposed that insurers should be discharged from liability only where there was a causal connection between the breach of warranty and the loss. For businesses, we proposed that this should be part of a default regime out of which the parties were free to contract. For consumers, we proposed that the regime should be mandatory.
- 4.6 In relation to the second problem, we proposed measures to ensure that terms were properly brought to a policyholder's attention. For mass-market business insurance contracts, we developed a scheme based on standard terms and reasonable expectations.

THE CAUSAL CONNECTION TEST

The basic test

- 4.7 We provisionally proposed that in both consumer and business insurance the policyholder should be entitled to be paid a claim if it can prove on the balance of probability that the event or circumstance constituting the breach of warranty did not contribute to the loss (12.55).
- 4.8 Seventy-four consultees responded to this proposal and fifty-seven (77%) of them agreed that a causal connection test was desirable.

Arguments in favour of the causal connection test

- 4.9 Commercial buyers were, as would be expected, strongly in favour of the proposal. AIRMIC believed that this was an essential change to insurance contract law. Barclays and HSBC argued that applying warranties in circumstances where the claim is unrelated to the breach is unjust. They said that they have the bargaining power, especially in a soft market, to negotiate warranties out of their contracts of insurance. It was their view, however, that many smaller companies were in need of protection. The Law Reform Committee of the Bar Council said that, "this would be in keeping with most people's sense of justice".
- 4.10 Consumer organisations were also in favour of the proposal. The National Consumer Council was "happy with the general principle requiring a contribution of the breach to the loss, which has applied anyway under the Statements of Practice".²
- 4.11 Many insurers supported the proposal. The ABI agreed that the principle would "afford important protection for policyholders". Some insurers argued that insurers and the courts already practised our causal connection test, or otherwise mitigated the harsh effects of warranties, even though it was not set out in strict law. The courts' practice of declaring that a warranty was a 'suspensive condition' and did not have the effect of discharging the contract was a practical way of dealing with the harsh effects of warranties. The British Maritime Law Association wrote:

² It was less happy with our proposals relating to the burden of proof, which we discuss at paragraph 4.20 below.

It should be noted that the Courts are ever more prepared to construe a non-material “warranty” as a suspensive or descriptive warranty, rather than a promissory warranty under section 33 of the Marine Insurance Act 1906. [British Maritime Law Association]

- 4.12 The Leeds Marine Insurance Association pointed out that insurers do not usually refuse a claim unless there is a causal connection.

In the experience of the working party, breach of warranty has only ever been used to avoid a loss where there has been a causal link. [Leeds Marine Insurance Association]

Arguments against the causal connection test

- 4.13 Eleven consultees (15%) felt that a causal connection test should not be introduced.

- 4.14 Some were uncertain that a causal connection test would work with all business warranties and policies. Consultees felt some warranties were so important that discharge should be automatic on breach and there should be no causal requirement between the breach and the loss. The International Underwriting Association of London made the point using the examples of class, surveys and crew maintenance warranties in marine hull business.

Requiring an element of causation when considering something as fundamental as ship safety would send out the wrong message in terms of managing moral hazard. We believe that in such situations, where insureds show a lack of due care and poor risk management, the insurer should be entitled as a default to avoid the contract. [International Underwriting Association of London]

- 4.15 The Royal Bank of Scotland supported the proposals but felt that the proposal may operate awkwardly with warranties which go to moral hazard, breach of which was unlikely to be causative. For example, if a business warranted that it would not employ people with criminal convictions, breach would be unlikely to cause a loss directly (unless the employee committed an act such as burgling the business), but it might increase the moral hazard generally. The Royal Bank of Scotland opined that the insurer should be able to avoid the contract in this case.

Overview of responses

- 4.16 Fifty-seven consultees (77%) supported a causal connection test for breaches of warranties as to the future in both business and consumer insurance. This is the same proportion as supported applying a causal connection test to warranties of past and present fact in business insurance (discussed in Part 3).

- 4.17 Many told us that they felt the law on warranties was far from certain at the moment. As a result, insurers and policyholders alike are unsure whether a breach of warranty will have strict consequences or not. Many thought that reforming the law so that insurers are liable for losses unconnected to breaches of warranty would improve certainty for all parties.

- 4.18 Eleven consultees (15%), however, did express reservations about the proposal. Some felt that applying a causal connection test to particular warranties, especially those related to safety or moral hazard, was inappropriate because it would be difficult to prove a causal connection in many of these cases, yet the moral hazard would be increased. This would lead to a rise in cost of premiums. Some insurers told us that a causal connection approach was their usual approach anyway, in which case these insurers would not be affected.
- 4.19 Others criticised our approach, saying that applying a causal connection test to breaches of warranties was ‘partial’ reform only. It is easy for warranties to be rephrased as limitations of cover or exclusions and it is difficult to justify applying a causal connection test to ‘pure’ warranties and leaving other terms unaffected. We discuss this point further at paragraph 4.58 below. By contrast, some argued that reform would encourage insurers to re-write their contracts avoiding warranties and using more conditions and exclusions, which are easier for policyholders to understand.

BURDEN OF PROOF

- 4.20 Under our provisional default regime the policyholder’s breach of warranty would not automatically discharge the insurer from liability. Instead a policyholder should be entitled to be paid a claim “if it [the policyholder] can prove on the balance of probability that the event or circumstance constituting the breach of warranty did not contribute to the loss”.
- 4.21 The burden of proof rests on the policyholder to prove that the breach was not connected with the loss. We asked about the burden of proof as part of the proposal relating to the causal connection above, so we do not have separate statistics for this part of the answer. The proposal above received seventy-four responses and fifty-seven (77%) of consultees agreed with it.
- 4.22 Some consultees, however, criticised the burden of proof point saying that “proving a negative is difficult”. Professor Clarke gave the following example, from the consumer context.

That is the case of the life assured, in breach of a warranty of abstinence, who was killed when struck by a railway train. Under the current rule of absolute warranties his wife’s claim on the insurance would fail. If he had just spent two hours in the Railway Arms, even under likely reforms his wife would get no more than sympathy. Even if he were scrupulously sober, under the current proposal might it not equally be said by an unsympathetic claims handler that the state of his constitution and his liver, in particular, was ‘a background factor contributing to the accident’? Would it not be difficult, if not impossible for his widow to prove otherwise? The possibilities are not endless but speculation could be sufficiently fertile to allow claims handlers to refuse to pay on little more than suspicion.³ [Professor Clarke]

³ Malcolm Clarke, “Insurance warranties: The absolute end?” [2007](4), *Lloyd’s Maritime and Commercial Law Quarterly* 474-493.

4.23 We appreciated that this rule may be harsh on consumers but warranties are rarely used in consumer insurance. It would be most unlikely, for example, that a man would be asked to warrant abstinence. Even if he were, the insurer would first have to prove that the warranty had been breached. Only if it proved that the man had drunk alcohol, would the burden of proof shift to his widow to show that the alcohol he had consumed did not contribute to the accident.

4.24 The National Consumer Council agreed that “proving a negative is difficult”. They argued too that the burden of proof should be on the insurer.

The effect of current practice and of the proposed reform is that the warranty would operate in a consumer context like an exception, and it is quite clear that in order to rely on an exception the insurer bears the burden of proof... We see no reason why this should not be the case regarding a causal connection between a breach of warranty and a loss. [National Consumer Council]

4.25 Those in the business market, however, felt that the burden of proof should be on policyholders. This appeared to be the view of both policyholders and insurers. NFU Mutual, for example, felt that it was “largely a sensible measure” that the burden should be on the policyholder to prove there was no causal connection.

Overview of responses

4.26 The majority of consultees agreed that the burden of proof (that the breach did not contribute to the loss) should remain with the policyholder for both business and consumer insurance. However, there was a significant body of opinion that thought that for consumer insurance the burden should be on the insurer, as proving a negative is difficult.

MANDATORY OR DEFAULT RULES FOR CAUSAL CONNECTION

Consumer insurance

4.27 We provisionally proposed that the causal connection rule should be mandatory in consumer insurance (12.57).

4.28 Fifty-five consultees gave their views on this question, all of whom agreed. The universal view was that the causal connection test for consumer insurance should be mandatory.

Business insurance

4.29 We provisionally proposed that, in business insurance, the parties should be free to vary the rules on the effect of a breach of warranty by agreement. However, where the insured contracts on the insurer’s standard terms, there should be safeguards to ensure that the term does not make the cover substantially different from what the insured reasonably expected (12.58).

4.30 Sixty-six consultees gave their views on this question and thirty-five (53%) agreed with our proposal. On reflection, it would have been better to ask this question in two parts: first, whether the causal connection test should be included in the default regime for business and, secondly, whether further safeguards were needed. We return to those safeguards at paragraph 4.55 below.

- 4.31 In relation to whether the causal connection test should be mandatory for business, buyers and brokers tended to feel that there should not be an option to contract out for businesses. They should operate under the same regime as consumers to give the system coherence. A mandatory causal connection test for warranties would be practical, they argued, given that insurers can exempt certain risks where they need to by using exceptions.
- 4.32 A second group, by contrast, felt strongly that there was no need for widespread changes in the business market. This group was made up mostly of insurers. The Liverpool Underwriters & Marine Association said:

a business insured was more able than a consumer to read and understand what to do and if that business failed to properly manage the risk it was fair that underwriters should be relieved of liability. [The Liverpool Underwriters & Marine Association]

Overview of responses

- 4.33 There was unanimous support for a mandatory causal connection test in consumer insurance.
- 4.34 For business insurance, consultees gave mixed feedback. If a causal connection rule is mandatory, then some complained that the parties' freedom to contract would be damaged. They felt that other provisions later in this Part (which restrict the right to contract out of the default regime when a party contracts on standard terms and those terms do not meet its reasonable expectations) would provide sufficient protection to unsophisticated parties. Others felt that this extra protection was not enough and that there should be a consistent approach to both consumer and business insurance.

BREACH CONTRIBUTING TO PART OF THE LOSS

- 4.35 If the policyholder's breach of warranty contributed only to a part of the loss, should the insurer still pay the claim in relation to the other portion of the loss? Our Consultation Paper provisionally proposed that if the insured can prove that a breach contributed to only part of the loss, the insurer may not refuse to pay for the loss which is unrelated to the breach (12.56).
- 4.36 In our Consultation Paper we gave an example of how this would work in practice for a business that has warranted to maintain a sprinkler system. If a fire starts and spreads from the well-maintained section of the building (A) to one where the sprinklers are not working (B), the insured is entitled to the part of its claim relating to the well-maintained section. If the fire spreads from section A to section B, the faults in section B cannot be said to have contributed to the loss in section A. It would of course be different if the fire spreads from the faulty section B. Here the breach would have contributed to the further loss in section A and the insured would not have any of its claim met.

- 4.37 Sixty-two consultees responded to this proposal and forty-nine (79%) agreed with it. The risk managers' association AIRMIC strongly supported this proposal, as did Age Concern. The ABI, Fortis Insurance Limited and Zurich Financial Services also agreed that, if a breach contributed to only part of the loss, the insurer should have to pay a claim for the remaining part and that this would be fair to policyholders.
- 4.38 The Lloyd's Market Association argued that an insurer may not refuse to pay if there is a complete distinction between two parts of the loss. However, they felt that if the breach has contributed to an element of the loss then the whole claim should fail. This would mean in our sprinkler example above that none of the claim would be payable. The International Underwriting Association of London and Allianz Insurance plc both predicted problems (and disputes) when distinguishing the causative from the non-causative element. This would particularly be the case for complex business risks like business interruption insurance. Others (both buyers and insurers) thought that the proposal was suitable for consumer insurance but not for business insurance.

Overview of responses

- 4.39 Forty-nine consultees (79%) agreed that, if the insured can prove that a breach contributed to only part of the loss, the insurer should not be able to refuse to pay for the loss that is unrelated to the breach. Others disagreed, saying that this would complicate the test and would unduly favour policyholders over insurers.
- 4.40 We asked in our Consultation Paper whether it was necessary to deal with breach contributing to part of the loss in an express provision in the legislation or whether the court might be able to reach this result in any event. There was a mixed response, with some saying that a statutory statement would serve as a useful clarification of the causal connection test. Most, however, did not accept that there was any need for an express statement of this particular issue.

BRINGING WARRANTIES AND OTHER TERMS TO THE ATTENTION OF THE POLICYHOLDER

Introduction

- 4.41 The second major problem we identified with warranties of future conduct was that policyholders are often unaware of the existence of warranties (and of other similar terms) and of the consequences of breaching them. We proposed a variety of measures to counteract this, both for consumer and business insurance.
- 4.42 For consumer insurance,⁴ the measures proposed were simply a tidying-up exercise. Warranties of future conduct are rare in consumer insurance. Further, consumer insurance is subject to the Unfair Terms in Consumer Contracts Regulations 1999 which give consumers protection against unfair terms. We therefore made two limited proposals for consumer insurance: first, that warranties should be set out in writing and, secondly, that they should be drawn to policyholders' attention.

⁴ See also paragraph 4.15 of the Consumer Summary Paper.

- 4.43 For business insurance, we proposed an alternative approach. We provisionally proposed that an insurer should not be permitted to rely on warranties, exceptions or definitions of the risk in its written standard terms of business if the term renders the cover substantially different from what the insured reasonably expected in the circumstances (12.58 and 12.59).
- 4.44 Below we discuss putting warranties in writing, which we proposed for both business and consumer policyholders. We then discuss our other proposals for bringing warranties and other terms to the policyholder's attention separately for consumers and for businesses.

Warranties to be set out in writing

- 4.45 We proposed that an insurer should not be able to refuse to pay a claim on the basis of breach of warranty if that warranty was not set out in writing (12.53). Warranties should therefore be set out in writing in the main contract document or in another document supplied either at or before the contract was made, or as soon as possible thereafter.
- 4.46 Sixty consultees gave their views specifically on this point and all bar one (98%) agreed with the proposal.
- 4.47 Insurers agreed that setting out warranties in writing was in line with current good practice. Before it was withdrawn, there was a requirement that warranties be set out in writing in the ABI's Statement of General Insurance Practice. One insurer said

warranties are a matter of great importance to both insurer and insured and it is therefore only appropriate that these terms should be clearly set out so that both parties understand the nature of the obligations they entail.

Overview of responses

- 4.48 All consultees bar one supported the proposal to put warranties in writing. However, in their responses to later questions about whether implied warranties and voyage conditions should be allowed in marine insurance, some consultees thought that these implied terms should remain. These would not be in writing in the contract. We return to the subject of implied marine warranties and voyage conditions at paragraph 4.91 below.

Bringing warranties to the attention of insureds – consumer insurance

- 4.49 Next we turned our attention to bringing these written warranties to the consumer policyholder's attention. We provisionally proposed that in consumer insurance, an insurer must take sufficient steps to bring a warranty to the policyholder's attention. In deciding whether the insurer has taken sufficient steps, the court should have regard to FSA rules or guidance (12.54).
- 4.50 ICOBS Rule 6 Annex 2, issued by the Financial Services Authority (FSA), states that the policy summary document should contain "significant or unusual exclusions or limitations". Significant or unusual exclusions or limitations are described as the following:

- (1) A significant exclusion or limitation is one that would tend to affect the decision of consumers generally to buy. An unusual exclusion or limitation is one that is not normally found in comparable contracts.
 - (2) In determining what exclusions or limitations are significant, a firm should, in particular, consider the exclusions or limitations that relate to the significant features and benefits of a policy and factors which may have an adverse effect on the benefit payable under it...
- 4.51 There is also the FSA requirement to treat customers fairly, contained in principle six of their High Level Principles, which applies to all insurers.
- 4.52 Fifty-seven consultees gave their views on this question and forty-eight (84%) agreed that an insurer must take sufficient steps to bring warranties to the attention of consumers. Many saw this proposal as instituting good practice. The ABI said that “consumers should be afforded this protection”. Others, including the Lloyd’s Market Association, the National Consumer Council, SCOR Global Life Reinsurance UK Limited and The Chartered Insurance Institute agreed with the policy because they felt that the proposals reflected current regulation. Not all, however, were convinced that it needed to be set out in legislation. The ABI and Fortis Insurance Limited felt that regulation, rather than legislation, was the answer. The perceived disadvantage is that legislation is not always adaptable to new products and information. However, our proposal is that regulation from the FSA should be used to determine when something has been properly brought to the attention of a consumer. This should ensure that methods can be kept up to date whilst avoiding the main disadvantage of pure regulation which is that a consumer has no direct remedy against an insurer if it breaches regulation.
- 4.53 Finally, one respondent questioned why this protection was being given in relation to warranties and not to other terms. The proposal could lead to an empty formalism whereby all warranties have to be brought to a consumer’s attention, whereas other terms which would have a similar effect do not.

Overview of responses

- 4.54 The majority of consultees supported the proposal and felt that an insurer must take sufficient steps to bring a warranty to the consumer’s attention. As we conclude in our consumer summary paper, however, we thought that the Unfair Terms in Consumer Contracts Regulations 1999 should remain consumers’ main substantive protection against unfair terms.⁵

BRINGING WARRANTIES AND OTHER TERMS TO THE ATTENTION OF POLICYHOLDERS – BUSINESS INSURANCE

- 4.55 The Unfair Terms in Consumer Contracts Regulations 1999 do not apply to business policies. Therefore, for businesses, we provisionally proposed an alternative way for bringing the written warranties to the attention of policyholders based on a test involving standard terms and reasonable expectations. Our aim was to ensure that mass-market business policies could not contract out of the default causal connection regime for warranties unless this had been specifically brought to the policyholder’s attention.

⁵ See paragraph 4.18 of the Consumer Summary Paper.

- 4.56 Many consultees agreed with the principle that some protection should be given to business insureds, especially small and medium sized enterprises. As the Royal Institution of Chartered Surveyors put it, when discussing the difference between the consumer and business regimes, many of its members are “sole practitioners [who] may be little more sophisticated than consumers”.
- 4.57 We therefore proposed that the parties should be free to vary the default rules on breach of warranty by agreement. However, insurers could not rely on this variation if:
- (1) the contract was on the insurer’s standard terms; and
 - (2) the warranties and their consequences did not match the policyholder’s reasonable expectations (that is, they had not been properly brought to the policyholder’s attention)(12.58).⁶
- 4.58 We also made a second, overlapping proposal. The scope of this second proposal was wider, covering warranties, exceptions and definitions of the risk, but the intention was similar. The proposal was that an insurer should not be permitted to rely on warranties, exceptions or definitions of the risk in its written standard terms of business if the term renders the cover substantially different from what the insured reasonably expected in the circumstances (12.59).
- 4.59 The reason we included this overlapping proposal is that warranties can be phrased in different ways.⁷ A business can ‘warrant’ that it will keep a burglar alarm in working order, or its policy could state that there is cover only when the burglar alarm is working. Both terms could have the same effect and we therefore proposed putting the same obligation on the insurer to bring them to the policyholder’s attention.

Standard terms limb

- 4.60 In relation to the standard terms limb, the rationale behind giving extra protection to businesses contracting on the insurer’s standard terms was that it would catch and protect those unsophisticated businesses who did not have the negotiating power or the sophistication to agree terms with an insurer. Instead they sign up to contracts on a ‘take it or leave it’ basis without much knowledge of what their alternatives were or the effect of breach of warranty. We expected sophisticated businesses to negotiate contracts and not sign standard terms. Under our proposals, if they did negotiate, they could agree that a breach of warranty would continue to be dealt with strictly.
- 4.61 As we have discussed in the context of the reforms listed in Part 3 of this summary paper, many consultees told us that it would be difficult to identify any insurance contract which was not on standard terms of some sort.⁸

⁶ There was also widespread confusion about the meaning of reasonable expectations and we shall return to this below.

⁷ See paragraphs 8.21 to 8.39 of the Consultation Paper.

⁸ See paragraph 3.94 above for further details of the arguments made by consultees.

The reasonable expectations limb

- 4.62 The second part of the proposals was to limit insurers' reliance on unexpected terms in their standard form contracts. This would provide a strong incentive for insurers to re-write their contractual documents in a way that their policyholders can understand.
- 4.63 Most consultees' comments were similar to those quoted in response to the 'reasonable expectations' limb on contracting out discussed in Part 3, above.⁹ Some felt that this test would not work in practice. Two insurers used the example of insurance on large construction projects where the lead contractor enters into insurance on behalf of sub-contractors. One pointed out that subcontractors do not usually see the policy unless they need to make a claim and therefore "a notice-based form of de facto regulation is unworkable". The other said that in construction risks the sub-contractor is invariably less sophisticated than the head contractor. This will lead to uncertainties about what has been understood and what is expected.
- 4.64 Others, mainly insurers, argued that businesses should not, as a matter of principle, be given this extra protection. However, the test is not designed to give blanket protection to all businesses. By using the concept of reasonableness, the standard can be adapted to the particular business. A sophisticated business would be expected to read and understand the small-print of a contract. An unsophisticated business who bought a commercial premises insurance contract would, by contrast, not be expected to pick-up from the small print that failing to maintain a sprinkler would lead to burglary losses not being paid, unless this was clearly spelled out.

Overview of responses

- 4.65 There were sixty-six responses to our first proposal (12.58) which limited the insurer's reliance on warranties where the contract was on standard terms and the warranty did not meet the policyholder's reasonable expectations. Thirty-five (53%) agreed with it.
- 4.66 There were fifty-eight responses to our second proposal (12.59) which limited the insurer's reliance on warranties, exceptions and definitions of the risk where the contract was on standard terms and the warranty did not meet the policyholder's reasonable expectations. Twenty-seven (47%) agreed with it.
- 4.67 As with the proposal relating to standard terms and reasonable expectations discussed in Part 3 above, it is difficult to be sure whether consultees disagreed with the approach in principle or whether they felt that the tests proposed were impractical (or both). Most consultees told us that they had reservations about how to recognise a 'standard terms' contract and the meaning of 'reasonable expectations', yet, despite this, around half the consultees supported the proposals, which suggests that there was some support for ensuring that terms are properly brought to the policyholder's attention. For example, one insurer felt that the proposals were aimed at treating customers fairly and should be encouraged to help build trust between insurer and insured.

⁹ See paragraph 3.101, above.

TERMINATING FUTURE COVER – CONSUMER AND BUSINESS INSURANCE

Termination of future cover

- 4.68 It is relatively rare for disputes to arise about future cover. Most disputes involving breach of warranty are over claims. However, if avoidance is not to be the automatic remedy for breach of warranty, a decision has to be made about future cover.
- 4.69 Under current law an insurer is automatically discharged from liability under the contract from the date of breach. If the insurer is automatically discharged from the date of breach, it cannot logically be liable to pay a subsequent loss unconnected with the breach. This would not fit with the proposals above. Nevertheless, breach of warranty, whether it leads to a loss or not, is still a breach of a term of the contract. The insurer should be entitled to some remedy for this breach if it is sufficiently serious.
- 4.70 We therefore proposed that the consequences for breach of warranty should be brought closer to normal contract principles so that a party is able to terminate a contract for another's breach if that breach is material. This is to say that it is a repudiatory breach. Our proposal was that a breach of warranty or other terms should give the insurer the right to terminate the contract, rather than automatically discharging it from liability, but (unless otherwise agreed) only if the breach has sufficiently serious consequences to justify termination under the general law of contract (12.60).
- 4.71 Sixty-one consultees responded to this proposal and forty-two (69%) of them agreed with it.
- 4.72 A few felt that the general law of contract in this area is too uncertain to provide insurers and policyholders with proper guidance. One party raised doubts about the suitability of general contract law to provide a precedent for when a breach is sufficiently serious as to constitute repudiation on the part of the policyholder.

As it seems likely that the policyholder will have complied with many or perhaps all other contractual obligations beyond the warranty in question, most cases will then fall to be decided by the doctrine of substantial failure in performance, not complete failure in performance. This is generally accepted to be a complex area of law subject to great uncertainty.¹⁰

Overview of responses

- 4.73 There was general approval of the move towards general contract law as a more proportionate remedy for breach of warranties.

¹⁰ Confidential response.

Effect on premiums of termination of future cover

4.74 If our reforms were to provide that a breach of warranty gives an insurer the right to bring a contract to an end, this raises a further question: should the insured continue to be liable to pay premiums after the contract is terminated? We proposed that they should not. The policyholder should not be liable for future premiums after future liability has been terminated.

4.75 We therefore asked whether consultees agreed that, if the insurer accepts the insured's breach of warranty, so as to terminate future liability, the insured should cease to be liable for future premiums (12.61). Sixty-one consultees gave their views on this question and fifty-five (90%) agreed that the insured should not be required to pay future premiums if the insurer terminates future liability.

4.76 Some, however, felt that this was a step too far. Ray Hodgkin wrote

If the assured is in breach, despite your extensive safeguards to the contrary then I do not see why the insurer should forfeit future premiums. [Ray Hodgkin]

4.77 Others, mainly lawyers rather than insurers, agreed that this proposal was contrary to principle. They agreed with the analysis given in *Chapman v Kardirga*¹¹ that the entire premium is earned on attachment.¹² They felt that it would be unjust to insurers if it were assumed that the cost of insurance and risk is spread evenly throughout the period of cover. It would discriminate against those who offered "free" introductory periods of cover.

Overview of responses

4.78 The vast majority of consultees, including most insurers, welcomed the proposal. They felt that it would meet policyholder's expectations since premiums are often in practice refunded pro rata when annual policies are cancelled part way through the year.

Pro rata refund of premium following termination of future cover

4.79 The previous question asked what should happen about premiums owing when the contract had been terminated. Our next question asked what happens when the premium has already been paid.

4.80 We asked whether an insurer who terminates a policy following the insured's breach of warranty should normally provide a pro-rata refund of the outstanding premium, less any damages or reasonable administrative costs (12.62).

4.81 Sixty-one consultees gave their views on this question and forty-nine (80%) of them answered in the affirmative.

4.82 Responses to this question were similar to those to the question above. Many insurers commented that this was the current good practice. However, two caveats were raised:

¹¹ *JA Chapman v Kardirga and others* [1998] CLC 860.

¹² That is, when the insurer starts to run the risk.

- (1) Some insurers, brokers and lawyers said that the insurer should not have to pay a pro-rata refund when the insurer had paid a claim. In these circumstances the insurer should be entitled to keep the whole of the premium. Amongst others, the ABI, Fortis Insurance Limited and the Liverpool Underwriters & Marine Association all made this point.
- (2) A buyer of insurance, Network Rail, said that the insurer should be able to deduct reasonable administrative costs from the premium returned. The Royal Bank of Scotland, Royal & SunAlliance Insurance PLC, the International Underwriting Association of London and several other insurers confirmed that this was the current good practice. The Financial Ombudsman Service felt that insurers must, however, prove the administration expenses. There should be no automatic right to retain a proportion of the premium.

Overview of responses

- 4.83 A large majority of consultees agreed that, when an insurer terminates cover for the future as a result of breach of warranty, the policyholder should be provided with a pro-rata refund of premiums. Some felt, however, that this general rule should not apply when a claim has been made. Others felt that the insurer should be able to deduct reasonable administration expenses, where they can prove that they were incurred.

Waiver and affirmation

- 4.84 Under the current law, when a policyholder breaches a warranty the contract is automatically discharged. The case of *The Good Luck*¹³ established that in insurance contracts, the only way that discharge can be avoided is if the policyholder can show that the insurer is estopped¹⁴ from relying on the discharge. This can only be done if the policyholder can show that the insurer made an unequivocal representation that it did not intend to rely on its legal rights and that the policyholder relied on that representation.
- 4.85 If, as we suggest, the contract is not discharged automatically for breach of warranty but instead the insurer has the right to terminate for repudiatory breach, then the question of whether the insurer is precluded by its subsequent conduct from exercising that right can be left to the general law of contract.
- 4.86 We therefore provisionally proposed that whether the insurer, by its conduct, has waived its right to treat the contract as at an end should in future be determined in accordance with the general rules of contract. We welcomed views on whether it is necessary to include a specific provision on this point in any new legislation (12.63).
- 4.87 Fifty-two consultees gave their views on this question and forty-eight (92%) agreed.

¹³ *Bank of Nova Scotia v Hellenic Mutual War Risks Association (Bermuda) Ltd* [1992] 1 AC 233.

¹⁴ The equivalent under Scots law is personal bar.

- 4.88 Most thought that it would be a good thing to bring insurance in line with general contract law. Lord Justice Rix warned that the law of waiver at common law was not terribly clear or satisfactory but nevertheless supported the proposal. The ABI agreed in principle as did other insurers and brokers.
- 4.89 When discussing whether waiver should be expressly provided for in statute or left to the common law, Lord Justice Rix pointed out that there are conflicting dangers of lack of clarity and coherence in the common law and ossification in statute. He did not think, however, that this point should be the subject of specific legislation. Academics, lawyers, brokers and some insurers agreed with him.

Overview of responses

- 4.90 Forty-eight consultees (92%) felt that the application of general contract law would be the best way of dealing with whether the insurer has waived its right to repudiate the contract.

WARRANTIES IN MARINE, AVIATION AND TRANSPORT INSURANCE

Introduction

- 4.91 We asked specifically about warranties in marine insurance because the law has traditionally taken a stricter approach to them. We thought it was right to consult on whether a causal connection test should be applied to marine, aviation and transport insurance (MAT) warranties and also about the implied marine warranties and voyage conditions set out in sections 39 to 41 and 43 to 46 of the Marine Insurance Act 1906. Below, we look first at the causal connection test in MAT and then at the implied marine warranties and voyage conditions.

Causal connection test – marine warranties

- 4.92 We provisionally proposed that a causal connection test should be applied to warranties in MAT, as with all other warranties.
- 4.93 One of the reasons for this was that it is difficult to define MAT. We discussed this above at paragraph 3.118. Removing MAT from the ambit of a new insurance contract statute would lead to two separate systems and disputes as to whether a particular insurance contract fell within one or the other. We therefore provisionally proposed that the causal connection test outlined above should apply to MAT(12.64).
- 4.94 There were thirty-five responses to this proposal and twenty-five (71%) agreed that a causal connection test should apply to MAT warranties.
- 4.95 A major broker agreed that the current law was out of line with the expectations of the international market and that it was unfair for an insurer to avoid paying a claim on the basis that there has been a breach which was not connected to the loss. Many of those who agreed with the proposal felt that as the parties to these contracts were so sophisticated it was important that it was easy to contract out of the default position if necessary.

- 4.96 Ten consultees disagreed with the proposal. These included a number of those who work in the marine market. The objections raised were to the principle of the causal connection test, and were similar to those raised by other respondents when commenting on the causal connection test at paragraph 4.14 and 4.15 above. They felt, for example, that the causal connection test would not work well with warranties addressing moral hazard. The Liverpool Underwriters & Marine Association strongly opposed the proposal saying, amongst other things, “it is currently difficult enough in consumer insurance to decide whether there is a causal connection between a breach of warranty and a loss which will become even more difficult in commercial insurance”. The Leeds Marine Insurance Association too felt that the position of the Marine Insurance Act 1906 should be maintained.

Overview of responses

- 4.97 Twenty-five consultees (71%) approved of the proposal to include MAT within the proposed reform of the consequences of breach of warranty. Those that disagreed felt that the MAT market worked well and did not need reform. They raised the same objections to the causal connection test as were raised in paragraph 4.14 and 4.15 above. They did not, however, tackle the problem of how to identify a MAT contract so as to exclude it from the rest of the market.

Implied warranties

- 4.98 The Marine Insurance Act 1906 implies four warranties into marine insurance contracts: seaworthiness, cargoworthiness, portworthiness and legality.
- 4.99 We asked whether the implied marine warranties in the Marine Insurance Act 1906 continue to serve a useful function or whether they should be abolished (12.65). This was a question to consultees, indicating that the Law Commissions had not reached a preliminary conclusion.
- 4.100 Thirty consultees gave their views on this question and sixteen (53%) thought that they do continue to serve a useful function. Those who argued in favour of retaining the implied warranties felt that they served a useful purpose and were well understood by the industry. The International Group of P&I Clubs, for example, said that these implied warranties are “very important”.

If they were not implied they would need to be expressed in the policy. The effect of these sections is well-known to marine insureds and their intermediaries. There does not seem to us to be a good reason not to retain them and they are a useful ‘short-hand’.
[International Group]

- 4.101 Those that argued that the implied warranties no longer serve a useful purpose said that all warranties should be express. Their responses are consistent with the responses given to the question we asked at 12.35 of the Consultation Paper¹⁵ about whether warranties should be in writing.¹⁶

¹⁵ See paragraph 4.45 above.

¹⁶ In relation to the question asked at 12.35, all consultees bar one felt that warranties should be set out in writing.

- 4.102 We also made a second point in relation to implied warranties. We proposed that, if the marine warranties are to be retained, they should be subject to the same causal connection test as express warranties (12.66).
- 4.103 Twenty-nine consultees gave their views on this question and sixteen (55%) thought that they should be subject to the same causal connection test as express warranties.
- 4.104 Several cautioned that these provisions form the basis for terms in policies and are well known. They argued that removal of the provisions would lead to uncertainty. Lloyd's commented that it was not aware of any pressure for reform and understands from the marine underwriting community within the Lloyd's market that they are fundamental.

Overview of responses

- 4.105 In relation to the implied warranties in marine insurance opinion was divided. On the one hand, some felt that implied terms have no place in a revised insurance statute and that to retain them would be against all the principles of openness which have been raised. However, a large number of those who work in the marine market were against any form of change at all. They wanted to keep the implied warranties and they did not think that any form of causal connection test should be applied to them.

Implied voyage conditions

- 4.106 In our Consultation Paper we pointed out that there are other provisions within the Marine Insurance Act 1906 which operate in a similar way to warranties. They are expressed as conditions precedent to the attachment of the risk.
- 4.107 We asked the same two questions about implied voyage conditions as we did for implied warranties. First, do they continue to serve a useful function or should they be abolished (12.67)? Second, if the voyage conditions are to be retained, should they be subject to the same causal connection test as express warranties (12.68)?
- 4.108 Twenty-seven consultees answered our first question and seventeen (63%) felt that there were good reasons to retain the implied voyage conditions. Twenty-three consultees answered the second point and fourteen (61%) of them agreed that the implied voyage conditions should be subject to the same causal connection test as express warranties.
- 4.109 Arguments were along the same lines as those above for the implied warranties. The Law Reform Committee of the Bar Council said that they were not aware of any problems caused by the provisions and suggested that unless those in the industry put up very strong reasons for abolishing them they should be retained. Those in the industry did not feel that they should be abolished. Royal & SunAlliance Insurance plc argued that marine insurance should not be treated in the same way as other forms of insurance and that the implied warranties and conditions continue to serve a useful purpose.

Overview of responses

- 4.110 A majority of respondents argued that the implied voyage conditions should remain in any new insurance contract statute. They felt that the market was used to these conditions and that it would avoid the need for them to be individually written into each contract. As with the point on warranties above, those who objected felt that the fact that the conditions were implied was contrary to the spirit of the reforms.
- 4.111 In relation to the causal connection test, a small majority argued that the implied voyage conditions should be subject to the same causal connection test. However many of those who were connected with the marine industry felt that this was unnecessary and impractical.

REINSURANCE

- 4.112 In our Consultation Paper we stated that, unless there are very good reasons to the contrary, the law on reinsurance should follow, as closely as possible, the law which governs the original insurance contract. We therefore proposed that the reforms proposed in relation to warranties should apply to reinsurance as well as to direct insurance (12.69).
- 4.113 Forty-one consultees gave their views on this question and thirty-four (83%) agreed that the reforms should apply to reinsurance as well as to direct insurance.
- 4.114 Consultees approached the issue from the point of view of whether direct insurance and reinsurance could be aligned in principle. The arguments they raised have been set out at paragraph 3.125 above in relation to misrepresentation and non-disclosure.

PART 5

INTERMEDIARIES AND PRE-CONTRACTUAL INFORMATION

INTRODUCTION

- 5.1 In our Consultation Paper we identified three issues involving intermediaries and pre-contractual disclosure which might benefit from reform. First, it is not always clear for whom an intermediary is acting when passing on pre-contractual information from the policyholder to the insurer. The consequence is that, if there is a failure to pass on information it is not always clear whether the policyholder should have its claim paid or not. The answer depends on whether the intermediary was the policyholder's agent. We discuss our proposals to clarify the position on this below.
- 5.2 Secondly, we looked at the case of *Newsholme Brothers v Road Transport and General Insurance Co Ltd*¹ and suggested that it was out of line with recent case law on this subject. It runs counter to some of our other provisions on disclosure, misrepresentation and breaches of warranty.
- 5.3 Finally, we made proposals in respect of section 19(a) of the Marine Insurance Act 1906.

FOR WHOM DOES THE INTERMEDIARY ACT?

- 5.4 As we described in Part 9 of our Consultation Paper, the law on agency as applied to insurance is often unclear. It is often difficult to work out whether an intermediary is acting for the insurer or for the policyholder when dealing with pre-contractual information.
- 5.5 In business insurance, however, the problem is not so acute as in consumer insurance. In the Consultation Paper we explained that in a business context it is relatively rare for insurance to be sold through intermediaries who deal with only one or a limited number of insurers. We were informed that the rare intermediaries who did deal only with one or a limited number of insurers served mainly small to medium sized businesses.
- 5.6 We did not want to affect intermediaries dealing with large businesses, believing that this was best left to the common law. We wrote that "for most commercial insurance, we are not proposing a change in the current law".²

¹ [1929] 2 KB 356.

² Consultation Paper, paragraph 10.58.

- 5.7 Instead we provisionally proposed that an intermediary should be regarded as acting for an insurer for the purposes of obtaining pre-contractual information, if it deals with only a limited number of insurers and does not search the market on the insured's behalf (12.78). The result would be that, where an intermediary who deals with only one or a small number of available insurers fails to pass on the information provided to it by the insured, then the insurer would have to pay the claim. As pointed out above, this proposal was aimed at the small and medium sized businesses market.
- 5.8 By contrast, where a business deals with an intermediary which undertakes a wider market search, we proposed that the common law should decide for whom the intermediary acts (12.79). This proposal was aimed at large businesses.
- 5.9 Sixty-one consultees gave their views on the proposal aimed at small to medium businesses and fifteen (25%) agreed. Forty-three (70%) did not agree that intermediaries who make a limited search of the market should always be deemed to act for the insurer.³
- 5.10 The main objection raised by consultees was that the test aimed at small and medium sized businesses would also catch larger businesses. Many pointed out to us that the situation was more complex than we had been told. Munich Re UK Life Branch, for example, was sceptical that all the differing relationships in the business and reinsurance contexts could be summed up in one single test.
- 5.11 Amongst others, Royal & SunAlliance Insurance plc, the British Insurance Law Association (BILA) and Hill Dickinson LLP suggested that it would be difficult to know what a 'limited number' of insurers was.

We could envisage a situation where a broker specialising in a particular risk may have such a detailed and extensive knowledge of his market that he knows the information already and does not need to undertake the exercise of conducting a market analysis. [Royal & SunAlliance Insurance plc]

A reasonable search in one geographical area or type of risk would be completely inadequate in another. [Hill Dickinson LLP]

For example, in specialist markets where there may be only very few or even only one potential insurer... the fact that an intermediary may deal with only a limited number of insurers does not necessarily suggest that they are therefore acting as agent for the insurer. [BILA]

³ The remaining 3 consultees made a comment but did not agree or disagree.

- 5.12 The Law Reform Committee of the Bar Council echoed the comments raised above about how difficult it is to determine whether an intermediary has carried out a limited search of the market. They pointed out also that the facts are almost exclusively in the possession of the intermediary. BILA, Aegon UK PLC, Grid (the Group Risk Development Group), Swiss Re and Royal & SunAlliance Insurance plc all questioned how businesses seeking to make a claim or insurers seeking to defend one would know whether the intermediary actually did carry out a fair analysis. BILA pointed out that neither party could prove a case without the co-operation of the intermediary.
- 5.13 Our second proposal was that intermediaries who make more than a limited search of the market should use the common law to determine who their principals are. Forty-nine consultees responded and thirty-nine (80%) of those agreed that application of the common law was the appropriate way to deal with identification of the intermediary's principal.
- 5.14 Network Rail and Lloyd's believed that the whole area of who the intermediary acts for should be dealt with using the common law. Others, however, including Lord Justice Rix, warned that the common law in this area was uncertain.

Overview of responses

- 5.15 We received a clear answer to our question about whether those intermediaries who only carried out a limited search of the market should always be regarded as acting for the insurer. As with consumer insurance, it appears that a bright-line test, whilst welcomed by some for its simplicity, would cause problems for many others. Most felt happier with the common law governing the situation, despite some uncertainty as to whether it could actually provide a clear answer to the problem of who an intermediary acts for.

THE NEWSHOLME CASE

Transferred agency

- 5.16 The case of *Newsholme Brothers v Road Transport and General Insurance Co Ltd*⁴ suggested that, even if an intermediary is an agent of the insurer, it should be considered to be an agent of the insured for the purposes of completing a proposal form. We believe that there is uncertainty as to whether this remains good law. *Newsholme* dates from 1929 and we have not found a contemporary case in which an insurer has attempted to raise the same point.
- 5.17 In our Consultation Paper, we therefore provisionally proposed that an intermediary who would normally be regarded as acting for the insurer in obtaining pre-contractual information should remain the insurer's agent while completing a proposal form (12.80).
- 5.18 Fifty-two consultees gave their views on this question and thirty-one (60%) agreed that there should no longer be transferred agency.

⁴ [1929] 2 KB 356.

- 5.19 The ABI, however, did not agree that there was any problem in the law relating to intermediaries and transferred agency. However, several insurers had differing views on what the law on this point was. Aviva plc and Nationwide Building Society considered that an intermediary is always the agent of the assured while completing a proposal form. Others, for example, Allianz Insurance plc, accepted that insurers should be responsible for tied agents when completing a proposal form. Another insurer stated that, despite its complexity, the current law worked.

Signature

- 5.20 The second part of the *Newsholme* finding related to the policyholder's signature. The case could be interpreted as having decided that a business insured's signature on a proposal form which has been completed incorrectly by a third person is conclusive evidence that the insured knew of or adopted what was written on the form.
- 5.21 It supports the proposition that, once a business has signed a proposal form in which an intermediary has made a mistake, that business cannot claim that it made an honest misrepresentation of one of the matters in the form. The fact of the signature turns the misrepresentation into negligence or even fraud.
- 5.22 We concluded that this finding was out of line with current practice. However, for business insurance there is one important caveat. In business insurance it would be permissible for the insurer to seek warranties of specific facts. Thus, if the insured signed a warranty that a fact was correct, this would give the insurer a right to refuse the claim. We believe that the warranty should be enough to put the proposer on warning that they should check the form carefully and a policyholder's signature would be decisive.
- 5.23 Our proposal, therefore, was that a business insured's signature on a proposal form which has been completed incorrectly by a third person should not be regarded as conclusive evidence that the insured knew of or adopted what was written on the form. However, this should not apply to a warranty of fact given by a business insured (12.81).
- 5.24 Fifty-two consultees gave their views on this question and thirty-six (69%) disagreed with the proposal, stating that it would encourage insureds to act recklessly. Many stressed that businesses operate professionally and should be held to account. Attendees at a Clyde & Co seminar argued that in the commercial world there was no reason why an assured should not conclusively be presumed to be aware of or have agreed to the contents of a document which they have signed. Many interpreted our proposal to be more radical than it was intended to be.
- 5.25 Some believed that the current law would allow the court to achieve the same result and that it was not necessary to overturn *Newsholme*. The City of London Law Society suggested that ordinary rules of evidence would enable the court to determine whether statements on the proposal form were attributable to the assured and their state of mind when making them.

Overview of responses

- 5.26 Most agreed that the *Newsholme* decision was an anomaly. Three consultees made the point that it did not fit in with the more recent law on apparent (or ostensible) authority and felt that, if *Newsholme* reached the court today, it would be decided differently in relation to the transferred agency point. There was a feeling that transferred agency does cause confusion in the law.
- 5.27 However, on the signature point, there was a strong feeling that the matter should be left to the common law.

MARINE INSURANCE ACT 1906, SECTION 19(a)

Introduction

- 5.28 Section 19(a) of the Marine Insurance Act 1906 states that

Subject to the provisions of the preceding section as to circumstances which need not be disclosed, where an insurance is effected for the assured by an agent, the agent must disclose to the insurer

- (a) every material circumstance which is known to himself, and an agent to insure is deemed to know every circumstance which in the ordinary course of business ought to be known by, or to have been communicated to, him...

- 5.29 In our Consultation Paper we identified three problems with this section:
- (1) the insurer's remedy for breach is to avoid the policy, which penalises not the broker (who was at fault) but the innocent insured;
 - (2) where there is a chain of intermediaries, the duty seemingly only applies to the final agent in the chain, the "agent to insure";
 - (3) it is unclear how far the duty extends to knowledge which the intermediary received in a different capacity.

Damages

- 5.30 In the Consultation Paper we proposed that where a broker breaches section 19(a), the insurer should no longer be able to avoid the policy against the insured. Instead a remedy in damages should lie against the broker (12.82).
- 5.31 Fifty consultees responded to this proposal. Twenty (40%) agreed, twenty-four (48%) disagreed and six (12%) made comments without agreeing or disagreeing.
- 5.32 Marsh and Guy Carpenter agreed that section 19(a) was outdated, but preferred repeal as it was concerned that the proposal would confuse the agency position of brokers. BILA, who agreed with the proposal, queried how it would operate against an agent of the insurer. Many thought that, where the intermediary was the agent of the insured, the insurer should continue to be entitled to avoid the policy.
- 5.33 We also asked three further questions about reform of section 19(a). We asked, if the section was retained, whether:

- (1) the right to damages should apply whenever insurance contracts are placed within the UK, or only where the contract is subject to the law of a part of the UK?
- (2) producing brokers should be obliged to pass relevant information up the chain to the placing broker?
- (3) the law should specifically state that an intermediary is not required to disclose information given to it in confidence by a third party? (12.83)

Should the right to damages apply whenever insurance contracts are placed within the UK, or only where the contract is subject to the law of a part of the UK?

- 5.34 We received thirty-five responses to this question. Because of the way the question was phrased it is not possible to give the number for those who agreed. Most respondents thought that the right to damages should apply whenever insurance contracts were subject to the law of a part of the UK. One major insurer pointed out that many contracts placed here are subject to foreign law, either expressly or by operation of conflict of laws rules. It felt that, in the circumstances, UK law should not interfere with the relationship between insurers, brokers and insureds. This point was echoed by, amongst others, Beachcroft LLP, Freshfields, The British Insurance Law Association, the Law Reform Committee of the Bar Council and Jardine Lloyd Thompson Group plc.
- 5.35 However, there was a significant minority who felt that the right to damages should apply when the contract is placed in the UK, regardless of the governing law of the contract.

Should producing brokers be obliged to pass relevant information up the chain to the placing broker?

- 5.36 We received forty-one responses to this question and thirty-four (83%) were in favour.
- 5.37 Many felt that without this proposal the duty to disclose would become meaningless in the context of international insurance and reinsurance. Freshfields argued that, although this suggestion, if implemented, would place more onerous obligations on the producing broker, it would lead to a reduction in the number of disputes surrounding the overall state of brokers' knowledge in relation to the presentation of risks.
- 5.38 The International Underwriting Association of London and the Investment & Life Assurance Group (ILAG) agreed with the proposal, subject to the rules on confidentiality which we proposed also being applied (see 5.40 below).
- 5.39 The British Insurance Law Association and the Law Reform Committee of the Bar Council, however, considered that there would be real problems imposing this obligation on foreign brokers. The British Insurance Law Association also thinks that the current law has not created any difficulties and therefore there is no need to reform it.

Should the law specifically state that an intermediary is not required to disclose information given to it in confidence by a third party?

- 5.40 There were forty responses to this question. Thirty-five (88%) thought that an intermediary should not be required to disclose information given to it in confidence by a third party.
- 5.41 Most felt that this would clarify the disclosure relationship. However, there was a divide between those who felt that this should be the subject of legislation and those who felt that it should not be. The Lloyd's Market Association felt that the regulatory framework already deals with situations where an agent is put in a difficult position; they must decline to act for the insured due to a conflict of interest. They struggled to think of any scenario where this consideration had ever arisen and therefore questioned the need for the proposal.

Overview of responses

- 5.42 Many consultees were unsure whether section 19(a) caused enough problems in practice for it to warrant being the subject of reform. Whilst some agreed with our reforms in principle, they also often felt that the matters were best left to the existing law or that the section should be repealed and the whole issue governed by the common law.