Robin Simon LLP

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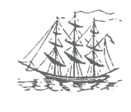

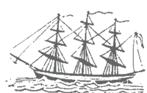

from Abroad.

Issue 1
December 2006

ROBINSIMONS

This is the first issue of our email newsletter “Home Thoughts from Abroad”. It will chart the progress of the reform of English insurance contract law in a series of brief notes over the next year or so. It follows our seminar in New York on 21 September 2006 (“Air too Pure to Breathe?”) when we looked at the current state of the law.

Reform of English insurance contract law has been in the offing for 50 years. In 1957 the Law Reform Committee (which numbered no less than five future law lords amongst its membership) recommended changes to the doctrine of good faith and misrepresentation. Similar comparatively modest reforms were proposed by the Law Commission's report[1] in 1980. In both cases, a complete lack of legislative activity ensued.

The Law Commission has now returned to the subject with a scoping paper published earlier in the year. This has been followed by a detailed issue paper on misrepresentation and non-disclosure issued in September (see below). It is intended that this will be followed by similar issue papers on warranties (to be published "at the end of November" 2006) and the important topic of agency and the post-contractual duty of good faith (publication date unknown).

This will be followed by a consultation paper (intended for publication in summer 2007) and, presumably, a full report – which is normally accompanied by a draft bill – some time later. All of this will be accompanied by a programme of seminars (which we shall attend) and ongoing consultation. Only following that will the lengthy legislative process start in parliament. It is estimated this will be in 2010.

Despite the cumbersome process, it seems that this is a project which will reach the statute book in the next five years. The judiciary in the appellate courts have made their view clear that reform is necessary and at least some in insurance market share their views[2]. There is now significant consumer pressure for a change in the law which seems to have a sympathetic audience in the current government. It remains to be seen whether that will be entirely fruitful if it cross-fertilises into the sphere of commercial insurance.

These proposals have enormous significance: a large volume of the world's

1. The Law Commission is a statutory body established in 1965 to keep the law in England under review and to recommend reform. A similar body, the Scottish Law Commission, deals with the law in Scotland. The papers on insurance law reform referred to in this newsletter are the product of a joint effort by both bodies.
   See the website, www.lawcom.gov.uk.
2. See in particular the September 2002 paper, Insurance Contract Law Reform, published by the British Insurance Law Association which can be found on its website (www.bila.org.uk) which helpfully sets out both judicial and market views.

insurance and re-insurance business is transacted on the London market subject to English law. It is estimated that in 2005 the London market's share of the world's reinsurance and commercial business was 10 to 15%. This rises in specialist fields to 15% (marine), 27% (aviation) and 60% (energy).

The global repercussions of reform will be enormous and, as with all legislative change, not always predictable. It is probable that a number of other common law countries which, for historical reasons, adopted a regime similar to the Marine Insurance Act 1906[3] will be encouraged to revisit their own law on the subject [4].

Misrepresentation and Non-disclosure – issue paper

The recommendations have to be seen against the background of current English law which is generally regarded as highly – some say unduly – favourable to insurers. Briefly, the insurer may avoid a policy for non-disclosure or a misrepresentation of material information. "Material" is defined by relation to whether the information would have had an impact (not necessarily decisive) on the mind of a hypothetical "prudent insurer". The insurer also has to prove that the non-disclosure or misrepresentation actually induced him to enter the contract. This doctrine is underpinned by a complex series of rules defining the knowledge to be attributed to the insured, what the insured does not need to disclose and waiver of disclosure by the insurer. Again, these rules are generally regarded as unusually favourable to insurers by comparison with other jurisdictions.

The issue paper proposes different regimes for consumer and "commercial" contracts – the former possibly including small businesses. Whilst this may seem a pragmatic approach, it will give rise to problems at a later stage because the dividing line between the two is not clear. We set out brief

3. The Marine Insurance Act 1906 codified the existing law relating to marine insurance in England prior to 1906. It is now accepted that before 1906 there was no distinction, at least as regards good faith, disclosure and misrepresentation, between marine and general insurance law. The Act therefore embodies the codified law relating to both marine and general insurance law.
4. The Australian Law Reform Commission (www.alrc.gov.au) has led the way hitherto. However, New Zealand (Marine Insurance Act 1908), Canada (Marine Insurance Act 1993), Singapore (Application of English Law Act 1993), Malaysia (Civil Law Act 1956), Hong Kong (Marine Insurance Ordinance 1956) and India (Marine Insurance Act 1963) still follow a regime similar to English law at least in the marine sphere.

details of the proposals for consumer policies first of all because they set the tone for what follows in relation to commercial insurance.

Consumer contracts

The "headline" proposals (described for the most part as "tentative recommendations") are:-

1. The test of materiality should be changed so that, first, the insurer must show that the non-disclosure or misrepresentation actually induced it to enter the contract on the same terms or at all. Secondly, a fact is material if the proposer actually knew it would have that effect or, if not, a reasonable proposer would have done so. In other words, this abandons the "prudent insurer" test of materiality and replaces it with a "reasonable insured" test whilst retaining the requirement for inducement.
2. The remedy of avoidance is limited to fraudulent non-disclosures or misrepresentations by the proposer. "Fraud" embraces both statements known to be untrue and non-disclosure of facts known to be material and recklessness in both cases. Currently, avoidance is available whether the misrepresentation/non-disclosure is fraudulent, negligent or even innocent.
3. The introduction of a defence for the insured that he or she had reasonable grounds for believing the truth of what he or she said or that he or she was not negligent in other ways (such as failing to answer a question). This is wholly new.
4. A proportionate remedy for negligent misrepresentation by asking what the insurer would have done if it had known the true facts. Where the insurer would have excluded particular claims it will not be obliged to pay those claims but will have to pay others; where the insurer would have declined the risk altogether it may refuse the claim; and where it would have charged an increased premium, that increase will be set off against the claim. Currently, the only remedy available in practice is avoidance.
5. The failure of the insurer to ask questions about specific matters in the proposal form will amount to waiver of disclosure of that information. This changes the existing law where there is no such waiver.
6. "General" questions in the proposal form will be permitted (as at present) but the court should ask what a reasonable consumer would have understood by them.
7. The insurer shall not be entitled to rely on non-fraudulent

misrepresentations made on renewals in response to questions about intervening changes in circumstances unless the insured has or is provided with copies of all information previously given to the insurer by the insured. Again, this changes the existing law where there is no such obligation.

8. "Basis" clauses will be ineffective.
9. The insured will have a new defence that the insurer cannot rely on a misrepresentation or non-disclosure where the insured reasonably thought the insurer would investigate and verify the matter. This is new.
10. The insurer is to be treated as knowing information contained in its own files provided it is reasonably identifiable. Again, this changes the current law.
11. Where an insurer has indicated that it will obtain information from a third party (such as medical advisers), the insurer cannot rely on a non-fraudulent non-disclosure/misrepresentation if the insured reasonably thought the insurer would check the information with the third party.
12. The insurer will be precluded from relying on non-disclosure or misrepresentation arising from an unanswered question in a proposal form which obviously requires an answer. This reverses the current law.
13. In life insurance, the insurer is precluded from relying on a non-fraudulent misrepresentation after three years.

It is probable that these rules will be under strapped by rules preventing contracting out etc.

Business contracts

The "tentative proposals" for business insurance contracts make interesting reading against this background:-

1. "… the law affecting business insurance should be changed to give the insured certain additional rights, but that the rules should in general not be mandatory".
2. The duty of disclosure will continue to apply.
3. The introduction of a "reasonable insured" test of materiality – presumably on similar lines to the proposal for consumer contracts above.
4. No restriction on the insurer's right to avoid for fraud.
5. Where the proposer has innocently made a misrepresentation, the insurer shall have no right to avoid.
6. Possibly, the introduction of a proportionate remedy (presumably on

similar lines to consumer contracts) for negligent misrepresentation.

7. Possibly also a change to the knowledge imputed to the insured (currently, everything which the insured ought to know in the ordinary course of its business).
8. Possibly also the introduction of a proportionate remedy (presumably for non-disclosure and misrepresentation) where other insurers would have accepted a risk at a higher premium.
9. In cases of negligent non-disclosure and misrepresentation, the insurer may cancel the policy on reasonable notice but without prejudice to claims (and presumably circumstances?) notified earlier under the policy. Currently, avoidance applies from the outset of the policy (ab initio).
10. A mandatory rule that incorrect answers in the proposal will not give rise to a remedy for breach of warranty absent a clause to that effect (and not just a "basis" clause) in the policy. See below regarding the current consequences of breach of warranty.
11. These proposals should apply to marine, aviation and transport ("MAT") policies – previously treated as a special, and exempt, category in e.g. the Law Commission's 1980 report.
12. No extension to the existing rights of third parties under liability policies[5].

Finally, some important questions are raised but not answered: should these proposals apply to reinsurance? and should small businesses fall within the rules for business contracts and, if so, how should small businesses be defined?

We suspect the first question (reinsurance) reflects a degree of uncertainty – and possibly lack of knowledge – about how these proposals might play out in an unfamiliar scenario.

The second question (small businesses) is troublesome since the Law Commission seems to be toying with a definition revolving around matters such as turnover or number of employees. The danger is that insurers underwriting a programme of say professional liability risks might find

5. The most significant are rights under the Third Parties (Rights against Insurers) Act 1930 which allows third party claimants to "step into the shoes" of insured defendants as regards claims against their insurers. The legislative purpose is to prevent the insurer's indemnity falling into the pool for distribution amongst all the insolvent insured's creditors. There are similar provisions in the Road Traffic Act 1988 applying to road traffic claims even where the policy has been avoided by the insurer.

some of their insureds falling under the "consumer" regime whilst others do not. Whether this is a real problem is not clear.

Summary and (tentative) conclusions

The Law Commission's approach in providing separate regimes for consumer and "business" insurance is probably pragmatic. What is slightly surprising, given the radical proposals for consumer insurance, is that the Commission has not gone further in respect of business insurance.

However, there are two proposals which will change the face of commercial insurance law significantly: the abandonment of the "prudent insurer" test for materiality in favour of a "reasonable insured" test and the introduction of proportionate remedies for the insured's breach of its duties of good faith.

The change to the test of materiality will take some time to work out in the courts. Basically, Judges will be faced with a conflict between submissions at either end of the spectrum on the lines that either the "reasonable insured's" understanding of what is and is not material will reflect what an insurer regards as material or that the "reasonable insured's" understanding is wholly independent. Neither is problem free. The former (conservative) approach could simply resurrect the "prudent insurer" in all but name. The latter (more radical) approach leads to a definition of materiality which is wholly independent of market assessment of the risk. Given the current mood of the judiciary in the appellate courts, it is obvious they want to get away from the current regime and will resist, for example, attempts to call expert underwriters to give evidence about matters which could be expected to inform the "reasonable insured's" understanding of materiality. Just how far they will go in the other direction remains to be seen.

The introduction of proportionate remedies is interesting. It will certainly extend the court's powers to re-write insurance contracts. However, the availability of less draconian remedies may encourage the courts to penalise breaches of good faith by the insured in circumstances where they have hitherto been reluctant to do so because only the draconian remedy of avoidance is currently available. This will also become particularly significant when the Commission goes on to examine the duty of good faith in the post-contractual context. Will it be tempted to allow

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the insured a remedy in damages for the insurer's breach of the duty of good faith? If so, that opens up the possibility of "bad faith" litigation which has hitherto been absent from English law.

Forthcoming – Breach of warranty

Under existing English law, breach of a warranty has punitive consequences for an insured – the insurer is discharged from liability from the date of the breach. So a false answer to a question in a proposal form which is a warranty relieves the insurer from all liability under the contract (see above).

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The experience of other jurisdictions is always interesting and helpful. If any of you have any observations on the contents of our newsletters or the proposed reform, please let us know. We can, if you wish, make representations on your behalf to the Law Commission.

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