

# Home thoughts, from Abroad.

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The Law Commission has now published its second Issue Paper examining warranties in insurance contracts<sup>1</sup>. Its “tentative proposals” contain few surprises but the scope of the Issue Paper has crept beyond warranties in the pure sense and the Commission is now looking at a general test of “fairness” in business insurance policies.

### The existing law

The existing English law on warranties<sup>2</sup> has (like so much else in English insurance law) been the subject of sustained criticism from the judiciary, consumers and commentators. It provides a regime which is (as with non-disclosure and misrepresentation) highly favourable to the insurer.

The effect of a breach of warranty is to discharge the insurer from liability from the date of the breach. This was decided by the House of Lords in *Bank of Nova Scotia –v Hellenic War Risks Mutual* (“The Good Luck”) [1992] 1 AC 233 – a decision which surprised many practitioners at the time. Remedy of the breach before the loss is irrelevant as is the absence of any causal connection between the breach and the loss. Thus a ship straying into a war zone in breach of warranty discharges its insurer from liability even after the ship has left the war zone. Likewise, an insured who fails to maintain a sprinkler system in breach of warranty is unable to recover indemnity in respect of a burglary.

This regime also means that it is probably not possible for an insurer to lose the right to repudiate by virtue of affirmation of the policy or estoppel. The insurer is discharged from liability from the date of the breach so that affirmation by the insurer or estoppel by reason of representations made to the insured are both irrelevant.

The use of “basis” clauses by which an insured warrants the truth of statements in the proposal form or submission has long been criticised. The Law Commission’s 1980 report recommended their abolition because they permit an insurer to repudiate liability even though the insured’s inaccurate statement was not material to the risk and even though the statement was made negligently (i.e. without fraud) or even innocently.

1. It can be found on the Law Commission’s website, [www.lawcom.gov.uk](http://www.lawcom.gov.uk)
2. Warranties in English insurance law require strict compliance. They may apply to past or existing matters (often contained in the proposal form or submission) or to a future state of affairs (for instance, to maintain burglar/fire alarms). Contrast conditions precedent to a claim – breach of which discharges the insurer from liability to pay the claim but not other claims under the policy; suspensive conditions where coverage in respect of particular circumstances is suspended during breach but not before or after; innominate terms where the remedy may range from repudiation to damages depending on the seriousness of the breach; mere terms – which only entitle the insurer to damages for breach. The status of innominate terms and the availability of repudiation has been seriously challenged by a Court of Appeal decision, *Friends Provident Life –v– Sirius International* [2005] 2 Lloyd’s Rep 517, where Lord Justice Mance observed that “English law is strict enough as it is in the insurers’ favour. I see no reason to make it stricter” (para. 33).

### The Law Commission's proposals

The Issue Paper adopts the general approach of the first paper on non-disclosure and misrepresentation (see Home Thoughts from Abroad, No.1) in recommending different regimes for consumer and "business" insurance policies. Thus the Commission makes the following tentative proposals (and asks for views):

1. Basis clauses should be of no effect in consumer policies. In business policies they should not be effective to turn statements of existing fact into warranties unless they are set out in the policy or in a document referred to in the policy and incorporated in it.
2. In consumer policies, statements of existing facts should be treated as representations not warranties. In business policies, the Commission suggests either that they should also be treated as representations or that breach of a warranty of specific facts should afford the insurer a defence to the claim provided there is a causal connection between the breach and the loss and also that various formal requirements were satisfied when the contract was made (basically, taking steps to draw the existence of the warranty to the insured's attention).
3. Turning to warranties about future facts and matters (in both consumer and commercial contexts), a claim should only be refused as a result of breach of a contractual obligation<sup>3</sup> if the obligation was set out in writing and included or referred to in the main policy document.
4. In consumer policies, a claim should only be refused if the insurer has taken sufficient steps to bring the requirement to the insured's attention.
5. Insureds should be protected from denial of their claims for reasons unconnected with the loss – in other words, the introduction of a "causation" requirement so that there has to be a connection between the breach and the cause of the loss – for example, the failure to maintain a sprinkler system and a loss caused by a fire.
6. Conversely, the insured should be entitled to be paid if he or she can show that the breach did not contribute to the loss.
7. If a breach contributes to only part of a loss, the insurer must pay the part not related to the breach. In the example above, if the fire spreads from a building where the sprinklers are working to one where they are not, the insurers will be liable to pay for the damage to the building in

3. This seems to envisage other contractual terms as well as warranties.

which the system was working. But they would have no liability if the fire spread from the unsprinklered building to a sprinklered building because the breach had contributed to the loss of both buildings<sup>4</sup>.

8. The causal connection rule should be mandatory in the case of consumer policies. The Commission goes on to invite views on whether it should be in business policies.
9. The Commission also invites views on whether the protection should apply to terms limiting the liability of the insurer for matters thought to increase the risk of a loss. This would apply not only to a warranty (e.g. that the insured vehicle is in a roadworthy condition) but also a term descriptive of the risk (e.g. the insurance only applies if the vehicle is in a roadworthy condition).
10. Likewise, the Commission invites views on whether the causal connection test should be subject to an exception where the insurance relates to one purpose, activity or place and the loss arises from another purpose or activity or in another place? Examples include a policy for vehicle drivers over 30 and the accident occurs whilst the vehicle is driven by a 20 year old or a ship in an excluded war zone<sup>5</sup>.
11. The causal connection test should apply to marine insurance.
12. The Commission invites views as to whether the warranties implied into marine insurance by the Marine Insurance Act 1906 should also be subject to the causal connection test<sup>6</sup>.
13. The Commission asks whether there are any reasons why these reforms should not relate to reinsurance contracts – mirroring the apparent uncertainty about reinsurance which we detected in their proposals regarding non-disclosure and misrepresentation (see Home Thoughts from Abroad, no.1).
14. Should a breach of warranty give the insurer the right to repudiate rather than automatically discharging it from liability (as at present – see above)?
15. Should an insurer have a choice between repudiating the claim only? Or the policy for the future? Or both?
16. Where the premium is paid by instalments, should the insurer's acceptance of the insured's breach of warranty terminate the insured's liability for future premiums?

4. The example given by the Law Commission.

5. Also examples given by the Commission.

6. These relate to seaworthiness and portworthiness (s.39 MIA), cargoworthiness (s.40 MIA) and the legality of the venture (s.41 MIA).

17. Where the premium has been paid, the Commission invites views whether the insurer should provide a pro rata refund following the insured's breach of warranty.
18. The Commission also invites views on whether an insurer should be obliged to give notice when terminating a policy in these circumstances, and on what would be a reasonable period of notice.
19. Finally, it will be possible for the insurer to lose the right to repudiate by waiver. This would bring English insurance law into line with general contract law.

In addition, the Commission goes on to extend its remit by inviting representations on whether the terms of business policies should be subject to a test of fairness. It considers that existing regulations regarding consumer policies (the Unfair Terms in Consumer Contract Regulations) adequately protect consumers' position.

### Conclusion

It is difficult to avoid the conclusion that a fairly modest review of the status of warranties and, in particular, basis clauses has grown into something with consequences stretching beyond the Commission's original expectations. The introduction of issues of fairness of policy wording is not without problems. It encourages an insured not to read the policy wording and rely instead on his or her "reasonable expectations" of what the policy might say. Also, it is not clear that the Commission has understood that a number of wordings in common use in the London market are prepared by brokers (normally the agents of the insured under English law).

For example, in the first Issue Paper on non-disclosure and misrepresentation the Commission had proposed that in the case of business policies the new regime should be mandatory and the parties, both insurer and insured, should retain freedom of contract. However, this approach has not survived the Commission's approach to basis clauses. As the current Issue Paper points out, it would be odd to impose a mandatory ban on the use of basis clauses if the insurer retains the freedom to "write back" a right to avoid for misrepresentation in the policy. It has solved this dilemma by proposing a mandatory regime for business policies as regards both basis clauses and non-disclosure/misrepresentation (see Home Thoughts from Abroad, no.1).

This suggests that the legislation emerging from the current exercise will

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be a full scale reform of English (and Scottish) insurance law going well beyond the relatively limited areas of non-disclosure and misrepresentation at inception and breach of warranty thereafter. This is not without dangers. Where do you stop? What might be the unforeseen knock-on consequences of all this? And in practical terms, how easy will it be to get a large and significant piece of legislation drafted and onto the statute book?

**Next up**

The Commission had promised a further Issue Paper on agency aspects of non-disclosure and misrepresentation (briefly, the difficult question whether an agent is acting for insurer or insured and whether the agent's knowledge can be attributed to the former). It is not clear when the Commission will move on to the post-contractual duty of good faith – another huge area which is likely to suck in the law relating to fraud, fraudulent claims and “fraudulent devices” used to support otherwise legitimate claims.

This is to be followed by a Consultation Paper in Summer 2007 – presumably to be followed by the Commission's substantive report. As we said in Home Thoughts from Abroad no.1, it does not look as though the legislative process will start until 2010 but that may be optimistic.

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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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