

Home thoughts, from Abroad.

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The Joint Consultation Paper

Overview

The Law Commission has now issued its Joint Consultation Paper dealing with the proposed reform of English insurance contract law in the areas of misrepresentation, non-disclosure, breach of warranty and the status of intermediaries. The consultation period will continue until **16 November 2007**. A further Consultation Paper will be issued next year dealing with post-contractual good faith, insurable interest and damages for late payment of claims. It is intended that this will lead to definitive proposals by the Commission for reform of insurance contract law which it is hoped (perhaps optimistically) will reach the statute book in around 2010.

Earlier editions of Home Thoughts From Abroad have dealt quite extensively with the Commission's proposals for reform of both consumer and business insurance law. The reason was that the Commission's views on business insurance were evidently influenced by its thinking about consumer insurance and the protection of consumers – which seems to be the driving force behind its proposals. This newsletter will deal with business insurance but it is important to remember the context of extensive and much more far reaching reform of consumer insurance. This will undoubtedly colour future case law relating to business insurance in an environment that will be more sympathetic to insureds.

The Commission's recommendations relating to both categories are summarised briefly in chapter 12 of its Paper¹. In summary, the headline recommendations so far as business insurance is concerned are:-

1. The replacement of the current test of materiality (namely, what would impact on the mind of a prudent underwriter) with a “reasonable insured” test.
2. The replacement of the existing remedy of avoidance of the policy for misrepresentation or non-disclosure (regardless whether fraudulent, negligent or innocent) with a compensatory or proportionate remedy.
3. Changes to the existing law on warranties where a breach discharges the insurer from liability under the policy from the date of breach without the need for any causal relationship between the breach and the loss.
4. In particular, the outlawing of “basis clauses” which convert the insured's answers to questions in the proposal form into warranties so that the insurer is discharged from liability if they are inaccurate (whether fraudulently, negligently or innocently).
5. A change in the current law regarding intermediaries which will make tied agents of insurers the agent of the insurer (and not, as at present, the insured) when they complete proposal forms on behalf of the insured.
6. Repeal of the current section 19(b) Marine Insurance Act 1906 which attributes a broker's knowledge to the insured.

The remainder of this newsletter concentrates largely on the proposals regarding non-disclosure and misrepresentation in the pre-contractual context and warranties. This seems to be the most important aspect of the proposed new regime.

1. We can supply copies with the kind permission of The Law Commission. It provides a helpful summary of all the main proposals. Please contact edward.coulson@robinsimonllp.com.

Non-disclosure and misrepresentation

Under current law the insurer is entitled to avoid a policy from the outset where there has been non-disclosure or misrepresentation of a material fact by the insured which induces the insurer to write the policy. “Materiality” is assessed by relation to what would have an effect on the mind of a hypothetical “prudent underwriter”. That effect need not be decisive as to whether or not to write the policy. It does not matter whether the non-disclosure is fraudulent, negligent or innocent. Finally, the non-disclosure need have no relation to a loss under the policy.

The law has long been criticised as unduly favouring the insurer and for reasons including:-

1. An archaic presumption that the insured knows everything about the risk whereas the insurer knows nothing – which may have been the case in the circumstances of marine insurance in the 18th Century but is not now correct.
 2. The insured’s difficulty in determining what will have an effect on the mind of a prudent underwriter – what is material – where (for example) the insured has no knowledge of the insurer’s underwriting criteria².
 3. The application of this doctrine regardless of whether the insured’s non-disclosure was fraudulent, negligent or wholly innocent.
 4. The absence of any relationship between the non-disclosure/misrepresentation and the loss under the policy.
 5. The draconian nature of the remedy – avoidance from inception – in proportion to what might be quite limited (albeit material) non-disclosure or misrepresentation.
 6. Finally, the concern that the law favours incompetent underwriters who failed to carry out a proper appraisal of the risk before inception but who manipulated the law so as to “do their underwriting in the claims department”. This has been partly allayed by the introduction of a requirement that the non-disclosure/misrepresentation must *induce* the insurer to write the risk. This became the law in 1995³.
2. This is mitigated to some extent if the insured relies on a broker’s advice when placing the cover. The broker’s failure to advise on what needs to be disclosed may give the insured a remedy against the broker. The Commission is not impressed by this because it is complex and leads to the insured having to make two separate claims against both insurer and broker – although such claims are commonplace in the Commercial Court in London.
3. In the House of Lords’ decision in *Pan Atlantic Insurance Co Ltd –v- Pine Top Insurance Co Ltd*. [1995] AC 501. Argument has continued over whether the evidential burden of proving inducement rests on the insurer or the insured. Current appellate authority seems to favour the former.

The test of materiality in the future will be whether a hypothetical “reasonable insured” would have appreciated that the fact was one that the insurer wanted to know *or* whether the proposer actually knew the fact was one the insurer wanted to know. The existing requirement that the non-disclosure or misrepresentation must induce the insurer to accept the risk is retained. The substitution of a “reasonable insured” test of materiality is not without problems. In particular, it is not clear what knowledge or other qualities are to be attributed to the reasonable insured. A further problem lies in the determination of what a reasonable insured would consider material anyway. It would be absurd if this extended to information which an insured wrongly thought material (but an insurer did not). However, this highlights the difficulty that the reasonable insured’s perception is surely going to be influenced by what an *actual* insurer considers material. Does this lead to the re-emergence of the ghost of the prudent underwriter?

The Commission’s view seems to be that this problem will be eliminated by the retention of the subjective test that the non-disclosure/misrepresentation must induce the actual insurer to write the risk. This may deal with the problem in some cases but not all. Take the disclosure of allegations of fraud against the insured which are subsisting at inception of the policy but (a) are irrelevant to the risk insured save as “moral hazard” and (b) subsequently prove to be false⁴. It is quite possible that the insurer could persuade a court that the suppression of such allegations induced him to write a risk that he would not otherwise have written. The enquiry then moves on to determine whether a reasonable insured would have disclosed them. It is easy to see this developing into a two stage enquiry in trial conditions: first, exactly *why* an insurer would treat the allegations as material (with expert evidence to that effect) and secondly, in the light of that evidence, why the reasonable insured should have realised they were indeed disclosable.

The knowledge of the actual insured will be attributed to him or her. But this will disadvantage the knowledgeable insured (for example, the reinsured under a reinsurance treaty) in contrast with the incompetent insured (who chooses not to make enquiries) and who will be favoured to the extent that he is taken to know only what a reasonable person would know⁵.

4. This has proved problematic under the existing law. See *North Star Shipping Ltd –v- Sphere Drake Insurance plc* [2006] EWCA Civ 378 and *Norwich Union –v- Meisels* [2006] EWHC 2811 (QB) for examples of the problems with the current law. Note also *Cuthbertson –v- Friends Provident* [2006] CSOH 74 where the Scottish Court of Session seems to have cut the Gordian knot and adopted a modified “reasonable insured” test in advance of statute law reform.

5. A sort of mirror image of the problem of the “incompetent underwriter”.

Turning to remedies, the Commission proposes that the insurer may still avoid for *fraudulent* non-disclosure/misrepresentation but may not avoid where the non-disclosure/misrepresentation is *innocent* (unless the contract provides otherwise). The Commission is undecided about the treatment of *negligent* non-disclosure/misrepresentation but invites views whether a compensatory remedy should apply. Thus, assuming the insurer had been provided with full information during placing, it may avoid the policy if it would have declined the risk on full disclosure. It would not be obliged to pay the claim if it would have excluded the risk on full disclosure. Finally, it may set off against the claim payment any additional premium if it would have charged on full disclosure⁶.

Warranties

Under existing law, the breach by an insured of a warranty discharges an insurer from liability under the policy from the date of breach⁷. It makes no difference that the breach is unconnected with the loss and, indeed, has not caused the loss.

The Commission has proposed a series of alterations to the current law. In particular:-

1. The warranty must be set out in writing in the policy or another document supplied to the insured at or as soon as possible after inception. This is not insignificant given the proverbially slow production of policy documents in the London market (despite recent improvement).
2. There must be a causal connection between breach of the warranty and the loss if the insurer is to refuse to pay the loss on grounds of breach – with the corollary that where *part* of the loss is not attributable to the breach, the insurer may not refuse to pay that part of the loss.
3. The parties may contract out of this provision save that where the insured contracts on the insurer's standard terms of business, there are to be safeguards to ensure that the cover is not substantially different from what the insured "reasonably expects".
4. More generally, where the insured contracts on the insurer's standard terms, there are to be safeguards to ensure that the warranty (and indeed other terms such as exceptions and definitions) does not make the cover substantially different from what the insured "reasonably expects".

6. Essentially, the "remedy" regime proposed for consumer insurance.

7. See section 33 Marine Insurance Act 1906 and *The Good Luck* [1992] 1 AC 233.

5. Finally, breach of warranty should give the insurer the right to terminate the policy rather than automatically releasing it from liability. The Commission goes on to ask for views on whether the insurer's acceptance of the breach should result in the insured no longer being liable for any future premiums otherwise falling due and whether the insured should receive a pro-rata refund of premiums already received.

The introduction of a requirement for a causal relationship between a breach of warranty and a loss represents a significant shift in English insurance law. However, the Commission seems to accept that commercial entities should be free to contract on the terms negotiated between them. In reality, though, the vast majority of policies in the London market are written on an insurer's standard terms.

The "reasonable expectations" approach proposed by the Commission goes a lot further than its proposals relating to a causal relationship between a breach of warranty and a loss: it extends (it seems) to "any term that defines cover in a way that policyholders would not reasonably expect".

The Commission considered but rejected an extension of existing law which enables the court to strike out "unfair" terms in non-insurance contracts. The "reasonable expectations" of the insured are, by contrast, more limited since they are determined by reference to the information received by the insured from the insurer and presumably elsewhere. Thus rather abstract (and much more wide ranging) considerations of "fairness" are excluded from consideration of whether a warranty etc. should be allowed to stand.

This is interesting because it suggests that insurers will need to explain to their insureds precisely why specific terms have been included in their policies and ensure that those policies are written in clear and comprehensible English (see further under "Implications" below).

References to the insurer dealing on "standard terms" are not clear and will need careful consideration at the drafting stage. At one end of the spectrum, there is the insured who engages his insurer in some limited negotiations about (for example) the limit of cover and deductibles but where the policy is still written on standard form wording. At the other end of the spectrum, there is the sophisticated insured with extensive bargaining power who is able to negotiate almost all the terms of cover. Just where is the line going to be drawn in determining when an insurer is providing cover on its "standard

terms”? And does this lead to the possibility that an insured could slip into and out of the “standard terms” regime depending on *how* it negotiated successive renewals?

The altered effect of breach of warranty (a right to terminate rather than an automatic release from the date of breach) is unsurprising. Indeed, it represents a return to what many practitioners understood the law to be before 1992.

The Basis Clause

Possibly the most controversial use of warranties is in “basis” clauses which convert the insured’s answers to the questions in the proposal form into warranties. If the insured misrepresents the position or fails to disclose answers to those questions, the insurer is relieved of liability from the outset. The insurer does not need to prove either materiality or inducement (as is the case with non-disclosure and misrepresentation). Further, as with other warranties (see above), it does not matter whether the inaccuracy in the answer is fraudulent, negligent or innocent nor is it necessary to prove any causal connection between the incorrect answer and the loss.

Not surprisingly, the Commission has proposed that “basis” clauses should be banned in consumer policies. In a commercial policy the clause should be set out in a specific term and the law should not uphold any term converting the answers in the proposal into warranties en bloc.

The Commission’s proposed “freedom of contract” provisions (see above) will apply but only to a limited extent: insurers will have to be selective as to the answers which they wish to convert into warranties and will have to explain the position fully and clearly. For example, in “claims made” liability policies (in particular) it is likely the insurer will want to ensure that the insured’s answers about its claims history are converted into warranties.

Again, clear policy drafting is going to be essential here (see “Implications” below).

Insurance intermediaries

After a slightly hesitant start, the Commission’s two main proposals in the field of business insurance are:-

1. A reversal of the current rule that a tied agent of an insurer who completes a proposal form for the insured becomes the agent of the

insured so that knowledge of information given by the insured to the agent is not imputed to the insurer (thereby enabling the insurer to decline liability for non-disclosure of that information)⁸.

2. Repeal of section 19(b) Marine Insurance Act 1906 which imputes the broker's knowledge of material information to the insured and enables the insurer to decline liability if it is not disclosed.

The first proposal is likely to have only limited significance since the use of tied agents, at any rate in the sphere of business insurance, is now quite limited.

The rationale of s.19(b) Marine Insurance Act has never been entirely easy to understand. However, its repeal may have implications in the not unusual situation in the London market where the broker acting for an underlying insurer persuades a reinsurer to reinsure the insurer on the basis that it will procure retrocessionary cover for the reinsurer. In this situation, the broker may know more about the underlying risk than the reinsurer. Currently, the broker's knowledge will be imputed to the reinsurer when placing the retrocessionary treaty.

Implications

Two predictions are safe if the Commission's proposals are embodied in the law:-

1. The immediate result will be a flush of litigation aimed at testing the new statutory provisions; and
2. The more enduring result will be increased stress on clarity not just in policy wordings but in other documents such as proposal forms and advertising material explaining the cover on offer.

The first prediction is reasonably self-explanatory. However, much will depend on the form of a new Insurance Act. If it adopts the approach of the 1906 Act in setting out broad rules for the courts to interpret, it will leave matters such as the attributes of the "reasonable insured" to the judiciary. Alternatively, if a "micro-regulatory" approach is adopted the legislation will attempt to prescribe these matters. On balance, we suspect the former approach is likely to work best: after all, the 1906 Act which also adopted this approach has always been reasonably clear (even if its effect is open to criticism). The difficulty with "micro-regulation" is that it is going to be almost impossible to

⁸. Thereby repealing the rule in *Newsholme Bros. -v- Road Transport and General Insurance Co Ltd.* [1929] 2 KB 356.

legislate for every possible situation in a complex, diverse and sophisticated commercial market.

The second prediction should be apparent from what we have said already. If insurers want to use the proposed “freedom of contract” provisions they will have to spell out warranties and other provisions very clearly along with (and this is new) the reasons they need them. Pleas for the use of “plain English and contract clarity have been with us for some time now. What is new is the need to explain to the insured *why* the disclosure of specific information is necessary (to inform the “reasonable insured”) and *why* specified warranties have been included in the policy (to shape the insured’s “reasonable expectations”). In short, we are looking at educating the business purchaser of insurance about the insurance market. Is it too much to hope that these proposals could lead to a new and slightly less cynical relationship between them?

Rounding up

This is of necessity a very brief summary of the Commission’s proposals for business insurance – we have not attempted to cover consumer insurance. The Consultation Paper runs to almost 400 pages and covers a lot of ground. There are numerous important areas such as the dividing line between consumer and business insurance and the treatment of reinsurance which remain fluid. We have not dealt with important proposals regarding (for example) the burden of proof in insurance disputes. Finally, there are some areas (co-insurance and waiver are important examples) where the Commission seems unsure how to proceed at present. We have, however, tried to summarise the most significant proposals which will affect those doing business in England in the years to come.

Participation

Please let us know if you have any views on these proposals. If implemented, they will be highly important and will affect the insurance market in this country fundamentally in the years to come.

It would be particularly helpful to learn the views of North American insurers not just on these proposals but also those forthcoming next year – particularly the duty of good faith in the post-contractual context. Hitherto, this has been an almost unknown concept on this side of the Atlantic. That is in marked contrast to North America and we should be interested in your views and experience.

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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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This is a brief summary of the Law Commission's proposals and is not intended to be a complete statement of them or of the existing law. You should not rely on it without seeking legal advice.