The Law Commission
and
The Scottish Law Commission

INSURANCE CONTRACT LAW

A Joint Scoping Paper

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

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The terms of this scoping paper were agreed on 21 December 2005 by the Scottish Law Commissioners and by the Commercial and Common Law Team of the English Law Commission.

The closing date for responses is **19 April 2006**. A response form can be found in Part 4 of the scoping paper, or may be downloaded from:

http://www.lawcom.gov.uk/insurance_contract.htm

Completed forms and other correspondence may be sent

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It would be helpful if, where possible, comments sent by post could also be sent on disk, or by email to the above address, in any commonly used format.

Responses will be treated as public documents in accordance with the Freedom of Information Act 2000, and may be made available to third parties.

The text of this paper is available on the Internet at:

http://www.lawcom.gov.uk/insurance_contract.htm
http://www.scotlawcom.gov.uk/downloads/cp_insurance.pdf

1 Until 31 December 2005.

2 With effect from 1 January 2006.

LAW COMMISSION AND SCOTTISH LAW COMMISSION

INSURANCE CONTRACT LAW

A JOINT SCOPING PAPER

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PART 1
INTRODUCTION

1.1 The English and Scottish Law Commissions are setting up a joint review of insurance contract law. We would very much welcome your views on its scope.

1.2 In its Ninth Programme, the English Law Commission said it would set up this joint project to examine at least two key areas of insurance contract law: non-disclosure (which will necessarily include misrepresentation) and breach of warranty. It said we would consult on whether there is a need to review other areas such as the law on insurable interest and on joint policies. No decision has yet been made as to whether other areas should be reviewed.

1.3 We would like to know whether you feel there are areas that we should review, and whether you think a statutory insurance code is desirable. In Part 4 of this paper we have asked you to list those areas you think we should review, and to rank them in order of importance. Your responses will be considered by the Commissioners before they determine the scope of this project in the light of the resources available to us.

1.4 Our current intention is that any reforms we may ultimately recommend will be intended to apply to England, Wales and Scotland.[1] Insurance contract law in Scotland is broadly similar to that in England and Wales. There are, however, some important differences. For example, in Scotland a policyholder may be able to claim losses caused by an insurer's unjustifiable delay in settling a claim, whereas in England this is not possible for the reasons we give in paragraph 2.64. There is also a different test for materiality in life insurance cases in Scotland.[2]

1.5 The English Law Commission last considered insurance contract law in 1980, when it looked at non-disclosure and breach of warranty. Its conclusion then was that the law was "undoubtedly in need of reform" and that such reform had been "too long delayed".[3] Reform was also urged in a report published by the National Consumer Council in 1997,[4] which considered a wider range of issues, including subrogation. The recommendations in these reports have not been implemented.

[1] The Law Reform Advisory Committee of Northern Ireland has asked us to keep it informed of developments.

[2] *Life Association of Scotland v Foster* (1873) 11 M 351.

[3] Insurance Law, Non-Disclosure and Breach of Warranty (1980) Law Com No 104.

[4] National Consumer Council, *Insurance Law Reform: the consumer case for review of insurance law* (May 1997).

1.6 A major factor in our decision to return to this area was the publication of a report by the British Insurance Law Association ("BILA") in 2002.[5] This report was prepared by a sub-committee with an impressive breadth of membership — academics, brokers, insurers, lawyers, loss adjusters, a self-regulatory body and trade associations. It included the text of lectures given by two senior members of the judiciary, and a foreword contributed by a third. BILA declared itself "satisfied that there is a need for reform" and put forward detailed proposals for change.

1.7 The review will have three stages. First, with this paper we are consulting on the scope of the project. Secondly, we will consult on the perceived problems within that scope, and possible solutions. Thirdly, we will prepare a final report and, if necessary, a draft Bill. We very much hope that all those with an interest in insurance contract law will become actively involved in the consultation processes, either individually or collectively through representative organisations. We have already met a wide range of organisations and individuals, and later in this paper we refer to some of the views that have been expressed to us.

1.8 The review will cover the law as it affects long-term and general insurance contracts. Both branches of the insurance industry have urged us to recognise the differences in the way they do business and, where appropriate, to reflect these differences in our proposals. In our next consultation paper, we will invite submissions on these issues.

1.9 It has also been suggested to us that some weaknesses in the law would be best addressed by statutory or self regulation rather than insurance contract law reform. Where appropriate, we will consider recommending a regulatory response. See, for example, the discussion of contract certainty in paragraph 2.36. However, we do not accept the arguments of one consultee who suggested that extensive rules from the Financial Services Authority ("FSA") and the mechanisms for change already in place were an adequate substitute for a review of the law.

1.10 For the remainder of Part 1 of this paper, we discuss some preliminary issues. In Part 2 we give some examples of areas other than non-disclosure and breach of warranty that might be included in the review, and ask for your views. We discuss the advantages and disadvantages of statutory codes in Part 3, and ask whether you think we should seek to produce such codes for insurance contract law. In Part 4 we list, for convenience, the nineteen questions we have asked. We set out in Appendix A the reasons that we concluded that non-disclosure and breach of warranty should be considered within the review. In Appendix B we explore some of the issues relating to insurable interest, and in Appendix C we give the text of those statutory provisions which it has been suggested could usefully be reformed.

1.11 The period of consultation on scope will end on 19 April 2006.

[5] British Insurance Law Association, *Insurance Contract Law Reform* (September 2002).

CATEGORIES OF POLICYHOLDER

1.12 In this paper we use the abbreviation "CSB" to refer to consumers and small businesses, and the abbreviation "MLB" to refer to medium and large businesses. We draw this distinction because the typical small business lacks specialist knowledge of insurance, may not have the resources to seek outside advice and does not have the bargaining power to agree special terms. Small businesses apparently face broadly the same problems as consumers. We note that the Financial Ombudsman Service ("FOS") is able to consider complaints from small businesses as well as consumers. It defines a small business as one with an annual turnover of less than £1 million. The questions of whether small businesses should be dealt with in the same way as consumers, and what should constitute a small business for this purpose, will be raised in our next consultation paper.

ARGUMENTS AGAINST REFORM

1.13 Most people to whom we have spoken support a measure of reform, though there are significant differences of opinion as to the extent and nature of change that is desirable. We are aware that there are some who oppose any consideration of reform. Here we set out the objections they raise. We do so not because we intend to reopen the question of whether we should review insurance contract law at all, but because you may find it useful to consider the points made, and our responses, when suggesting which areas you believe should be within the review.

1.14 Few of those who argued against reform did so on the basis that the current state of the law is satisfactory. Instead, the suggestion most commonly put to us was that the need to address any potential unfairness in the law was removed or outweighed by one or more of the following factors:

(1) The strict law is not in practice applied in consumer cases because of the existence of voluntary codes, the rules of the FSA and the service offered by the FOS.

(2) MLB policyholders usually have access to professional advice and their bargaining power may be equal to that of insurers.

(3) Some of the legal remedies may seem draconian, but it is important that they remain available to insurers as a negotiating tool. This is particularly so when fraud is suspected but cannot be proven.

(4) The current law offers a degree of certainty — reform is a leap into the unknown, and may have unanticipated and undesirable consequences.

(5) Given various European initiatives, domestic reform should be deferred.

1.15 We explain below why we do not believe that these factors present a compelling case to avoid or defer review of the law.

Consumer cases

1.16 Where the law gives rise to problems, CSB policyholders are entitled to refer disputes to the FOS. The Ombudsmen take account of regulatory rules and guidance and good industry practice, as well as the law, in making decisions that are fair and reasonable in all the circumstances. These rules and practices include the conduct of business rules issued by the FSA. Ombudsmen may also make use of certain statements of practice published by the Association of British Insurers ("ABI"), under which insurers agreed not to enforce all of their strict legal rights against consumers. Most significantly, a statutory "fair and reasonable" discretion has been used by the Ombudsmen to develop an alternative approach to the law in resolving disputes.

1.17 We are struck by the views expressed by one Ombudsman who felt that the FOS should not be regarded as a substitute for law reform. His view was that the fact that most CSB disputes are not now heard in the courts may impede the development of the common law, and make reform more rather than less necessary. The present position is increasingly incoherent, with a growing gulf between apparently unsatisfactory law on the one hand and a patchwork of codes, rules and Ombudsmen principles on the other. We are also conscious that certain policyholders — including some in vulnerable classes — are less likely than others to make use of the service offered by the Ombudsmen. Furthermore, there are limits on the Ombudsmen's jurisdiction and authority. Our concern is that CSB policyholders may, as a result, face the full rigour of the law. MLB policyholders do not, in any event, have access to the service offered by the Ombudsmen.

MLB policyholders

1.18 It has been suggested to us that the law should remain unchanged for MLBs, since they are capable of looking after their own interests. We accept that many MLBs have access to expert advice — in some cases in-house as well as external. Additionally, the larger the business, the more likely it is that it will be able to influence the terms of any policies it effects. One consultee told us, for example, that when placing substantial risks on behalf of his firm, he simply refuses to have warranties in any policy.

1.19 However, the fact remains that for the typical MLB, insurance is merely an ancillary matter to its business. It is not an area in which it specialises.[6] Expert advice may ensure that businesses are aware of the potential pitfalls, but it cannot remove any unfairness inherent in the current law. Many MLBs are not of a size that will enable them to bargain effectively with insurers. Furthermore, any such ability may be adversely affected by matters outside the control of the MLB — for example, large losses in the previous policy year.

1.20 In our view, therefore, MLBs should not be excluded from the scope of the review.

[6] One exception is reinsurance — see para 2.70.

Negotiating tools

1.21 It has been suggested to us by industry consultees that an insurer may reserve its position on a technical defence, whilst negotiating to settle a claim. The reasoning given is that a policyholder will be more open to reasonable negotiation when the alternative is to face the full rigour of harsh law. We are not in a position to say whether such tactics are common practice or exceptional. However, in either event, we are not sure that it is an appropriate stance for an insurer to take. In Appendix A we explain how the current law entitles an insurer to avoid a policy — that is, set it aside from outset — for an entirely innocent non-disclosure that has no connection with any loss that has occurred. Allowing an insurer in such circumstances to dangle a Damoclean sword of avoidance over a policyholder creates an undesirable imbalance of power between the parties.

1.22 We have also been told that one argument for retaining harsh remedies for, say, innocent non-disclosure, is that fraud can be extremely difficult to prove. Fraud is, we accept, a significant concern for insurers, and we address the issue in paragraphs 2.43 to 2.48. However, we are concerned by the implication that an insurer should be free to choose whether or not to make use of a harsh remedy, based on its subjective perceptions of the honesty of the policyholder. There is an obvious potential for injustice if the insurer's suspicions are not in fact correct. In any event, it is not appropriate for an insurer to have the right, in effect, to decide whether the claim should be rejected on the ground of fraud that has not been proven.

Certainty

1.23 As we outline in Part 2 and Appendix A, we do not believe that the current law has an acceptable level of certainty, even in respect of fundamental concepts such as utmost good faith. We appreciate that the industry has concerns that any reform carries the risk of unforeseen consequences. In our view, this risk can be minimised if all interested parties engage with the consultation process. We are encouraged by the co-operation and support that we have already received. Additionally, we have the advantage of being able to consider the success or otherwise of reforms which have already been implemented in jurisdictions such as Australia.

Europe

1.24 There are European initiatives that may eventually have some influence on insurance contract law. In particular, we are aware of the work being conducted by the Restatement of European Insurance Contract Law Project Group ("the Innsbruck Group"),[7] which is drafting the rules for the Common Frame of Reference on Insurance Contract Law. These rules could form the basis for a European Directive or possibly a "26th regime" optional contract law instrument. Our attention has also been drawn to the Opinion of the European Economic and Social Committee on "The European Insurance Contract" adopted on 15 December 2004.

[7] http://www.restatement.info/ (last visited 20 December 2005).

1.25 Despite these developments, most of those to whom we have spoken nevertheless regard harmonisation of insurance contract law as a distant prospect. Several consultees commented that there would be more chance of influencing the outcome of harmonisation if domestic reform had already taken place. The reason given was our current insurance contract law is both unfair and unusual, so that any suggestion it should form the basis of a harmonised regime is unlikely to be successful. In these circumstances, we will be monitoring European developments, but do not see any reason to delay the current review.

PART 2
POSSIBLE AREAS FOR REVIEW

2.1 In this part of the paper we give some examples of areas of insurance contract law — besides non-disclosure and breach of warranty — where reform may be desirable. We ask in each case for your opinion as to whether the matter should be included within the review. As these are merely examples, we conclude this part of the paper with an invitation for you to list any other areas that you feel should be reviewed.

INSURABLE INTEREST

2.2 The doctrine of insurable interest restricts the availability of valid insurance to those who can show a particular type of interest in the life, property or liability to be insured. This is a complex area of law, which relies heavily on old case law and archaic statutes, notably the Life Assurance Act 1774. We give further details in Appendix B.

2.3 There appear to be two objectives behind the development of the doctrine:

(1) The prevention of gambling under the guise of insurance.[1]

(2) The deterrence of moral hazard.

2.4 Preventing gambling under the guise of insurance may still be a strong argument for retaining restrictions on the ability to insure. From a regulatory perspective, it may be thought desirable to separate those who are using insurance to order their affairs prudently from those who are merely gambling. A doctrine of insurable interest is probably a more effective and convenient way of enforcing such a separation than through, say, a statutory definition of insurance.

2.5 In our early discussions, some of those in the insurance industry supported the retention of a requirement of insurable interest to deter moral hazard. Their concern is that if insurance were to be available without restriction it could act as an incentive to crime. For example, if it were possible to insure the life of a stranger, a person might be tempted to do so, and then obtain payment by bringing about that stranger's death. A contrary view is given by one academic:

> It is submitted that the requirement of insurable interest, whether as strict as that required by English law or not, does not appear to serve its purpose; and that, in principle, people should be allowed to insure other people or their property…. If A, for reasons which A knows best, values B's life enough to pay premiums, why not let A do so? Why not trust people? Why not trust the police, who will be the first to look at A if B dies suddenly, and society at large to see that B is safe from A?[2]

[1] See R Merkin, "Gambling by Insurance – A Study of the Life Assurance Act 1774" (1980) 9 *Anglo-American Law Review* 331.

[2] M A Clarke, *Policies and Perceptions of Insurance Law in the Twenty-First Century* (2005) p 38.

2.6 Even those arguing that the requirement of insurable interest should be retained have agreed with three broad criticisms of the existing law:

(1) The law is inaccessible and uncertain. In establishing the legal position it is necessary to consider a range of old cases and statutes. These sources may be unclear — for example, there is still doubt as to whether the Life Assurance Act 1774 applies to indemnity as well as contingency insurances.

(2) The law is unduly restrictive. For example, spouses may insure each other's lives. Cohabitees, however, do not gain such a right merely as consequence of cohabitation.

(3) The law lacks coherence. It has been developed piecemeal and there are anomalies and omissions.

2.7 Although there was general agreement that the law in this area is unsatisfactory, some consultees argued that reform should not be a high priority. Several stated that the law is in some respects simply ignored in practice; another suggested that points on insurable interest are only taken by insurers where fraud is suspected. These seem to us to be arguments for rather than against reviewing the area.

2.8 Practical issues were also raised. A consultee pointed out that there is a problem with parents insuring cars which are really for the use of their children, in an attempt to reduce the premiums charged. He suggested it would be undesirable if any reform of the law on insurable interest were to undermine the message that such actions are unacceptable.

2.9 If we are to look at insurable interest, we believe we should do so across all types of insurance and all categories of policyholder. In addition, we are conscious that there are two other areas which may achieve part of the objectives of insurable interest and which will therefore need to be given at least some consideration. First, the principle of indemnity, which operates to prevent a claim being successful if a loss has not been suffered. Secondly, the definition of insurance, which could restrict insurers' ability to offer cover where there is no interest.

2.10 **Do you agree that insurable interest should be included in the review?**

A DEFINITION OF INSURANCE

2.11 There is currently no statutory definition of insurance. No doubt there would be difficulties in arriving at a satisfactory exhaustive definition, and we are aware that there may also be some disadvantages in attempting to do so:

> The danger of definitions is that, being sharply inclusive, they may also be damagingly exclusive. Unrestrained by definition the courts can accommodate new products, perhaps new kinds of investment or financial reinsurance.[3]

[3] M A Clarke, *The Law of Insurance Contracts* (4th ed 2002) p 1.

2.12 Nonetheless, several consultees have suggested that this is an area that could usefully be reviewed. Different motivations appear to be in play. One consultee was keen to expand the definition of insurance so that insurers could become involved in new lines of business. A second wanted to address the blurring of the boundary between insurance and other means of financial risk transfer, and a third simply wanted firm edges to the regulatory boundary. A fourth felt it was unfortunate that firms were currently able to arrange their business in such a way as to bring it inside or outside the regulatory boundary as they wished. He felt that consumers might not realise that certain warranty contracts were not insurance policies, and that if problems arose they would not be able to refer complaints to the FOS.

2.13 **Should we consider introducing a statutory definition of insurance?**

AGENCY AND INSURANCE

2.14 It is common for an intermediary to be involved in insurance transactions — for example, a prospective policyholder may seek advice from an insurance broker. For some purposes, including those outlined below, the status of the intermediary is crucial in deciding the legal outcome. However, the applicant may not appreciate the importance it bears. Furthermore, there is clearly the potential for confusion, particularly given that an intermediary may wear different hats during the course of a transaction. When dealing with an application for motor insurance, for example, a broker may act as agent of the applicant in obtaining quotations, then switch to being agent of the insurer in issuing a cover note.

Non-disclosure

2.15 On occasion, an applicant for insurance will disclose material facts to an intermediary that the intermediary fails to pass on to the insurer. The question then arises — has the applicant met the obligation of disclosure? If the intermediary was acting as agent of the insurer, the obligation of disclosure is met, regardless of whether the insurer ever receives the information. If, however, the intermediary was acting as agent of the applicant at the relevant time, the answer must be no: telling one's agent is no better than telling oneself. Given that a breach of the duty of disclosure may subsequently allow an insurer to avoid a policy and refuse to pay any claim, it is perhaps not surprising that the situation has been the subject of criticism in the courts.

Case Study 1[4]

Mr Roberts insured a hotel through a Lloyd's broker. The hotel operated a discotheque, which the broker was shown when he inspected the premises. Following a fire, Mr Roberts made a claim for £70,000. Underwriters sought to avoid the contract on the ground of non-disclosure of the discotheque.

Hodgson J found that the information had been waived, but criticised the defence raised by underwriters.
If the insurers' contention is correct, this Plaintiff is yet another victim of the insurance industry. He made the fullest disclosure to the broker; like the majority of laymen he probably thought that that was enough and that the broker was the agent of the insurers by whom he was remunerated by way of commission; that mistake was one which, unhappily, is all too common, and all too often used by insurers to escape liability.[5]

His comments were supported by Purchas LJ in the Court of Appeal:
To the person unacquainted with the insurance industry it may seem a remarkable state of the law that someone who describes himself as a Lloyd's broker who is remunerated by the insurance industry and who presents proposal forms and suggested policies on their behalf should not be the safe recipient of full disclosure; but that is undoubtedly the position in law as it stands at the moment. If I may say so, Mr Justice Hodgson's strictures on this matter are more than justified. Perhaps it is a matter which might attract the attention at an appropriate moment of the Law Commission.[6]

2.16 Following this case, the Insurance Ombudsman indicated that pending legislation he would, in appropriate cases, hold insurers responsible for the defaults of intermediaries.[7]

Other issues

2.17 It has been suggested to us that there are other aspects of agency in insurance that we could usefully consider. For example, we understand that there are concerns over conflicts of interest generally, and over the involvement of intermediaries in the claims process. Difficulties may arise where a premium is paid to an intermediary but is not then passed to the insurer, and there is the broader question of who should bear the risk of fraud by the intermediary. In a review of this area we would, of course, need to consider the effect of any relevant rules issued by the FSA.

4 *Roberts v Plaisted* [1989] 2 Lloyd's Rep 341.

5 Unreported, but quoted in the Court of Appeal - *Roberts v Plaisted* [1989] 2 Lloyd's Rep 341, 343.

6 *Roberts v Plaisted* [1989] 2 Lloyd's Rep 341, 345.

7 Insurance Ombudsman, *Annual Report* (1989) paras 2.13 to 2.15.

2.18 **Do you agree that we should consider the law of agency insofar as it relates to insurance?**

SUBROGATION

2.19 Where an insurer indemnifies a policyholder in respect of a loss, it has a common law right of subrogation. This means that the insurer may stand in the shoes of the policyholder and pursue a recovery from a negligent third party. The action is brought in the name of the policyholder but for the benefit of the insurer.

2.20 This is, for example, common practice in motor insurance. If a policyholder claims under a comprehensive policy for damage caused by another driver, the insurer will pay out under the policy. Proceedings may then be brought against the negligent driver in the name of the policyholder.

2.21 Subrogation can benefit policyholders. If the insurer makes a recovery, a policyholder may retain rights to a "no-claims discount". Less directly, the level of recoveries may affect premium rates — though whether the effect is significant may be doubted.[8] There are, however, circumstances in which pursuing a right of subrogation may be undesirable.

> **Case Study 2[9]**
> Mr Lister and his son worked for Romford Ice and Cold Storage Co Ltd. Whilst reversing a lorry in the course of his employment, the son through his negligent driving injured the father. The father claimed against Romford Ice and was ultimately awarded £1,600. Romford Ice was insured against this liability, and made a claim.
> Having settled the claim, the insurer brought a subrogated action against the son — in the name of Romford Ice — to recover its outlay.
> By a majority, the House of Lords held that it was entitled to do so.

2.22 The insurance industry subsequently accepted that it was not appropriate to pursue recoveries against negligent fellow-employees and entered into a voluntary agreement — known as the "Lister v Romford Ice Agreement" — not to enforce its rights in such circumstances.

2.23 Mortgage Indemnity Guarantee policies ("MIGs") provide another example of how subrogation has arguably unfortunate effects. If house purchasers wish to borrow more than a certain percentage of the value of a property, a MIG may be sold to cover the risk that there will be a shortfall if repossession proves necessary. When house prices slumped in the 1990s, many properties were repossessed and sold. Where MIGs were in place, insurers paid the shortfalls to the lender. Borrowers assumed that was the end of the matter.

[8] M A Clarke, *Policies and Perceptions of Insurance Law in the Twenty-First Century* (2005) p 290.

[9] *Lister v Romford Ice & Cold Storage Co Ltd* [1957] AC 555.

2.24 In fact, although the premiums had been paid by the borrowers, the MIGs had apparently been written for the benefit of the lenders. The insurers were therefore able to stand in the shoes of the lenders and pursue recoveries from the borrowers. They had six years to do so.

> **Case Study 3**[10]
> Mr T's house was repossessed and sold by the building society which had granted him a mortgage to buy it. Five and a half years after it was sold he received a demand from the insurer which had underwritten the associated MIG. The insurer was claiming its outlay of £6,000 plus accumulated interest over the intervening period.

2.25 In 1997, the National Consumer Council suggested that there was also the potential for subrogation to operate unsatisfactorily in the family context:

> In theory a member of a policy holder's family, such as a teenager who negligently caused a fire by not putting out a cigarette properly, could be pursued by the insurer.[11]

It argued that there was a case for restricting rights of subrogation against family members and employees and — other than in certain circumstances — against anyone who had paid the premium for the policy in question.

2.26 **Do you agree we should consider the law of subrogation?**

"WORTHLESS" POLICIES

2.27 Several consultees raised the issue of policies sold to policyholders who would never be able to make a claim. An example is unemployment cover sold to someone who was self-employed — even though the policy terms expressly excluded such risks. Many such cases may never come to light — the policyholder will not have cause to make a claim, and so will continue to pay premiums, oblivious to the fact that the cover is worthless.

2.28 An Ombudsman drew our attention to the work recently conducted by the FSA in relation to payment protection insurance. In a study of thirty firms, the FSA concluded that around half

> failed to take reasonable steps to ensure that customers do not buy policies they cannot claim on or which provide only very limited cover.[12]

[10] National Consumer Council, *Insurance Law Reform: the consumer case for review of insurance law* (May 1997) p 69.

[11] Above, p 33.

[12] Financial Services Authority, *The Sale of Payment Protection Insurance — Results of Thematic Work* (November 2005).

One industry consultee argued that this finding was not indicative of the standards in the industry as a whole, and that current initiatives by the FSA, the Office of Fair Trading and the industry should be allowed to bed down before review was considered.

2.29 We suspect that it might be more appropriate for mis-selling of this nature to be addressed by general provisions against unfair commercial practices rather than insurance contract law. It may be that some clauses which have the effect of reducing the value of the policy to the policyholder will be susceptible to challenge under the Unfair Terms in Consumer Contracts Regulations 1999.[13] However, these are possibilities which could usefully be considered as part of a review.

2.30 **Do you agree that we should review the issue of "worthless" policies?**

JOINT POLICYHOLDERS

2.31 It is common for policies to be effected by more than one policyholder. For example, a couple may effect a joint policy to insure the home in which they live, and its contents. Likewise, in English law the partners in a business partnership may effect joint policies to protect the business assets. In either case the omissions and acts of one policyholder — for example, in not disclosing material facts, in deliberately causing a loss or in making a fraudulent claim — may adversely affect the rights of others.

> **Case Study 4[14]**
> A married but separated couple were joint owners of a matrimonial home and its contents, all of which they had jointly insured. Distressed by what he viewed as his wife's desertion, the husband set fire to the house. The wife's subsequent claim was rejected by the insurer.
>
> The Ombudsman accepted that the insurer might be correct in law — though there was no judicial decision on the point. However, he concluded that the result was inequitable:
> *For a wife's own claim to be defeated by her husband's default seemed to involve an uncalled for penalty. Certainly this result would have been out of touch with modern ideas of the independence of spouses — man and wife are no longer seen as one person. In our judgment, the just and reasonable outcome was that a joint policyholder, such as the wife, should be paid half the claim.*

2.32 We think there is a need to review the question of whether in some circumstances a policy should be construed as containing separate contracts between the insurer and each co-insured as distinct from a single indivisible policy.

[13] SI 1999 No 2083.

[14] Insurance Ombudsman, *Annual Report* (1989) paras 2.36 to 2.37.

2.33 **Do you agree that we should consider the position of joint insureds?**

"CONTRACT CERTAINTY"

2.34 Problems can be caused where the terms of an insurance policy are not expressly settled at inception. The context can be as simple as a household policy arranged by a consumer over the telephone, or as complex as the cover effected on the World Trade Centre prior to the 9/11 terrorist attack. The FSA has identified three issues relating to what has become known as contract certainty. Where terms have not been settled:

(1) Policyholders do not have certainty as to the details of the cover they have bought.

(2) Brokers face considerable reconciliation issues and risks of errors and omissions.

(3) Insurers do not have an accurate view of the risks they write, so may not hold appropriate levels of capital.

2.35 It is clearly desirable for policy documents to be issued promptly, but this begs a number of questions. Should all the terms of the contract be included in a single document, or is it acceptable to refer to external sources? What is meant by "promptly", and what remedies or penalties should apply if the requirement is not met? Any review would also need to take into account the wide variety of means by which insurance is sold.

2.36 There was unanimity amongst early consultees that contract certainty is an issue which needs to be addressed. However, many felt that it could be tackled more effectively through market agreements than through law reform. We were given details of the work being conducted by the FSA in this area and encouraged to consider two existing codes of practice — one issued for London Market contracts by the Market Reform Group, and another issued jointly by the ABI, the British Insurance Brokers' Association and the Institute of Insurance Brokers.

2.37 **Should we consider the issue of contract certainty?**

POST-CONTRACTUAL GOOD FAITH

2.38 Much attention has focussed on the extent to which the duty of utmost good faith extends beyond the formation of an insurance contract. On the face of it, section 17 of the Marine Insurance Act 1906 appears unlimited in its scope:

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

In *The Star Sea*[15] it was held that this principle is not limited to marine insurance; it applies to all forms of insurance. Lord Clyde indicated that attempts to limit the duty to the pre-contractual stage appeared to be "past praying for". Instead, he suggested that the nature of the duty might vary in its content or substance depending on the stage in the contract:

> It is reasonable to expect a very high degree of openness at the stage of the formation of the contract, but there is no justification for requiring that degree necessarily to continue once the contract has been made.

2.39 In *The Aegeon*[16] Mance LJ accepted that the court should proceed on the basis that the duty applied post-contractually, whilst "expressing the hope that the House of Lords judicially or Parliament legislatively might one day look at the point again..."

2.40 Recent cases demonstrate the uncertainty in the law. The courts have had to consider the nature and extent of the duty, whether it extends into subsequent litigation, the impact of fraudulent devices and the issue of whether interim payments can be recovered on the basis of subsequent fraud.

2.41 There is broad agreement amongst those to whom we have spoken that this is an area which could usefully be reviewed. Our provisional view is that consideration of the post-contractual duty of good faith will inevitably require consideration of the broader issue of fraud, since the two areas are so closely related.

2.42 **Do you agree that we should review the post-contractual duty of good faith?**

FRAUD

2.43 Policies frequently contain specific conditions addressing fraud at the claims stage. In addition, there is a common law rule on fraudulent claims. This rule provides that a policyholder who makes a fraudulent claim forfeits any lesser claim which could legitimately have been made:

> Suppose the insured made a claim for twice the amount insured and lost, thus seeking to put the office off its guard, and in the result to recover more than he is entitled to, that would be a wilful fraud, and the consequence is that he could not recover anything.[17]

2.44 We are told that fraudulent claims are still a major concern for insurers. In March 2005, the ABI indicated that the mean total value of dishonest claims detected each week was £3.5 million. Some claims represent one-off frauds by individuals, others involve criminal gangs engaged in activities such as the staging of motor accidents. Inevitably, honest policyholders face higher premiums because of the costs of dealing with fraud.

[15] *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd* [2001] UKHL 1, [2003] 1 AC 469, 482.

[16] *Agapitos v Agnew* [2002] EWCA Civ 247, [2003] QB 556, 563.

[17] *Britton v Royal Insurance Co* (1866) 4 F & F 905, 909 by Willes J.

2.45 One consultee expressed concern that it was hard to enlist the assistance of the police in securing a prosecution — he felt that finding a route to easier prosecutions would create a greater deterrent. Another observer argued that there was good reason for insurers to take an active role in our review:

> While the debate will cover far more than simply the impact of fraudulent claims, there can be no reason why any draft Insurance Law Review Bill produced by the Law Commission cannot include a statutory definition of fraudulent conduct consistent with the new Fraud Bill. The Act could set out the consequences of insurance fraud for all to recognise, thereby putting an end to ambiguous policy wordings and an unclear set of common law rules.[18]

2.46 Concerns were also raised with us from a policyholder's perspective. What is fraud, and how can it be distinguished from honest negotiations? What standard of proof should be required for allegations of fraud? To what extent does the duty of good faith apply to the insurer? Is it obliged to disclose to the policyholder any expert reports it obtains? Should it always make a fair settlement offer or is it entitled to negotiate to a lower figure?

2.47 Again, the solution to any problems may not lie wholly in insurance contract law, but there may be a case for us considering both what amounts to fraud in the insurance context, and what the consequences should be of any such fraud.

2.48 **Do you agree we should review the law as it relates to fraud in the making of a claim, and the definition of fraud for this purpose?**

REPEALS

2.49 The long history of insurance in the UK, and the lack of recent reform, inevitably means that there are statutory provisions that may appear out-of-date and anomalous. Four specific examples have been raised with us. The text of these provisions is given in Appendix C.

Marine Insurance Act 1906, section 22

2.50 Section 22 provides that a contract of marine insurance is inadmissible in evidence unless it is "embodied in a marine policy". This appears to envisage a formal written record of the contract.

2.51 In 2001 the English Law Commission published an Advice on electronic commerce. It concluded that in the absence of reform of the 1906 Act, a marine policy cannot be an electronic document.[19] Subsequently, BILA, in its 2002 report, suggested that section 22 should be amended to deal explicitly with electronic trading. Other provisions of the 1906 Act identified by BILA as possibly benefiting from reform include sections 41 and 55(c).

[18] Nick Young, "Winning the war on fraud" [15 December 2005] *Insurance Times* 14.

[19] Law Commission, Electronic Commerce: Formal Requirements in Commercial Transactions (19 December 2001) Part 7, available at http://www.lawcom.gov.uk/docs/e-commerce.pdf

2.52 **Do you agree that section 22 of the Marine Insurance Act 1906 should be reviewed?**

Marine Insurance Act 1906, section 53

2.53 Where a policy is effected through a broker, section 53(1) makes the broker directly responsible to the insurer for the premium.

2.54 It has been suggested to us that this provision no longer reflects the realities of the insurance market place, and it should therefore be repealed or amended. We have not conducted the research necessary to establish whether there is consensus on this point.

2.55 **Do you agree that section 53 of the Marine Insurance Act 1906 should be reviewed?**

Marine Insurance Act 1788

2.56 This Act originally required any policy of insurance on ships or "goods, merchandises, effects or other property" to contain the names of one or more interested parties. If the requirement is breached, the policy is rendered null and void. The Act was repealed by the Marine Insurance Act 1906 "so far as it relates to marine insurance". Consequently, it appears the 1788 Act only applies to non-marine policies on goods.

2.57 It has been suggested that the 1788 Act is of little value, that its title is now very misleading and that it might therefore usefully be considered within a review of insurable interest.

2.58 **Do you agree that the Marine Insurance Act 1788 should be reviewed?**

Fires Prevention (Metropolis) Act 1774, section 83

2.59 This provision is intended to deter property owners from setting fire to buildings to claim the insurance proceeds. It gives any "person interested" the right to insist on the insurer settling a claim by reinstating the buildings rather than by making a cash payment.

2.60 It has been suggested to us that this provision should be reviewed on five grounds:

(1) Its wording is archaic and obscure.

(2) It has in certain respects been rendered obsolete by sections 47 and 108 of the Law of Property Act 1925.

(3) It does not reflect the potential complexity of rival claims to any payment under a policy.

(4) Its stated purpose is the deterrence of arson, but it must be questioned whether it has any such effect — the vast majority of policyholders are unlikely to be aware of its existence.

(5) It is anomalous in that it probably does not apply to Lloyd's underwriters.

In addition, our attention has been drawn to the fact that in Scotland the provision does not apply. If it is to be retained, it is suggested we should consider whether it should be extended to Scotland.

2.61 **Do you agree that section 83 of the Fires Prevention (Metropolis) Act 1774 should be reviewed?**

2.62 **Are there other existing statutory provisions which should be reviewed with a view to amendment or repeal? If so, please give details.**

UNJUSTIFIABLE DELAY

2.63 Delay in settling a claim can cause significant hardship for a policyholder. Where the insurer has unjustifiably caused the delay, it might be thought that the policyholder should have a right not just to have the claim settled but also to be compensated for any consequential losses.

2.64 However, in English law a claim under an insurance policy is, in current law, a claim for damages. There is no right to damages for late payment of damages.[20] In such circumstances the courts merely have a discretionary power to award interest. Often an award of interest will not reflect the policyholder's true loss.

[20] See J Lowry and P Rawlings, "Insurers, Claims and the Boundaries of Good Faith" (2005) 68 *Modern Law Review* 82.

Case Study 5[21]

Mr Sprung owned a small business. He had insured machinery against "sudden and unforeseen damage". There was a break-in at the premises, and the machinery was damaged beyond repair. The insurer denied liability on spurious grounds, and there was a delay of nearly four years before it settled the full claim under the policy with interest. In the meantime, the business had collapsed.

Mr Sprung claimed £75,000 for the losses caused by the insurer's initial refusal to indemnify him. The Court of Appeal reluctantly found that such losses were not recoverable. The award of interest was Mr Sprung's only remedy.

I do not find the defendants' submissions at all attractive, either from a commercial or from a moral point of view.[22]
Evans LJ

There will be many who share Mr Sprung's view that in cases such as this such an award is inadequate to compensate him or any other assured who may have to abandon his business as a result of insurers' failure to pay, and that early consideration should be given to reform of the law in similar cases.[23]
Beldam LJ

2.65 In contrast, Scots law treats the obligation of the insurer as a contractual obligation to pay a sum of money equivalent to the policyholder's loss.[24] There is no rule that the only remedy for failure to settle a claim promptly is an award of interest. In *Margrie Holdings Ltd v City of Edinburgh District Council*,[25] it was held that the test for the recovery of consequential losses is one of reasonable foreseeability within the general rules set out in *Hadley v Baxendale*.[26] Those rules provide that where one party to a contract breaches it, an innocent party who is affected is entitled to damages in respect of losses that either:

(1) may fairly and reasonably be considered as arising naturally from the breach – that is according to the usual course of things, or

(2) may reasonably be supposed to have been in the contemplation of both parties at the time they made the contract as a probable result if it were breached.

21 *Sprung v Royal Insurance (UK) Ltd* [1997] CLC 70.

22 Above, p 79.

23 Above, p 80.

24 *Lithgow Ltd v Secretary of Defence* 1989 SC (HL) 9, *Strachan v The Scottish Boatowners' Mutual Insurance Association* (unreported).

25 *Margrie Holdings Ltd v City of Edinburgh District Council* 1994 SLT 971.

26 *Hadley v Baxendale* (1854) 9 Exch 341.

2.66 We are aware that other jurisdictions take a different approach to such cases. Indeed, some allow not just the recovery of consequential losses, but also the possibility of punitive damages where an insurer has acted in bad faith.

Case Study 6[27]

Mr and Mrs Whiten owned a house in Ontario, Canada. A fire destroyed the house and all its contents. The property was insured by Pilot Insurance Company. After small initial payments, Pilot decided to decline the claim on the grounds of arson. This was despite the fact that the local fire chief, Pilot's own expert investigator, and its initial expert were all agreed that there was no evidence of arson. A Canadian jury awarded $318,252.32 in compensatory damages and $1million in punitive damages. Although the award of punitive damages was reduced to $100,000 by the Court of Appeal it was restored by the Supreme Court:

The more devastating the loss, the more the insured may be at the financial mercy of the insurer, and the more difficult it may be to challenge a wrongful refusal to pay the claim. Deterrence is required. The obligation of good faith dealing means that the appellant's peace of mind should have been Pilot's objective, and her vulnerability ought not to have been aggravated as a negotiating tactic. It is this relationship of reliance and vulnerability that was outrageously exploited by Pilot in this case. The jury, it appears, decided a powerful message of retribution, deterrence and denunciation had to be sent to the respondent and they sent it.

Binnie J

2.67 Punitive damages are not generally available in UK law, and we doubt that an exception is either appropriate or likely to be introduced in this case. However, the present position does not seem satisfactory. It may be useful for us to review the area generally, and the issue of whether an insurance claim under English law should now be considered as a debt and the possibility of introducing compensatory damages in particular.

2.68 One industry consultee supported a review of this area, but felt that any right to compensatory damages should be limited to those cases where the consequences of the delay were grave for the policyholder — for example where the policyholder was forced into bankruptcy.

2.69 **Do you agree we should consider the remedies available to a policyholder when an insurer unreasonably delays the settlement of a claim?**

[27] *Whiten v Pilot Insurance Co* [2002] 1 SCR 595, para 129.

REINSURANCE

2.70 An insurer will commonly purchase insurance itself — to transfer to other insurers part of the risks it has accepted. This type of arrangement is known as reinsurance. For the most part, the law applying to reinsurance policies is currently the same as that applying to insurance policies. Some consultees have suggested that confusion will result if reinsurance law does not remain broadly in line with insurance law.

2.71 **Do you agree that the review of general principles of insurance law should include their application to reinsurance?**

OTHER ISSUES

2.72 We hope that this part of the paper has given you an idea of the wide range of issues which could be looked at within the review. Other possibilities mentioned to us in early discussions include:

(1) Waiver and estoppel.

(2) The form of policies — notably the complexity of wordings and the amount of "small print".

(3) The burden and standard of proof in claims.

(4) Group policies.

(5) Renewals.

A non-exhaustive list of areas we might review can be found in the schedule in paragraph 3.4.

2.73 **What other areas of law would you like us to review? Please give brief reasons for your views.**

PART 3
STATUTORY CODES

3.1 We invite views as to whether we should address merely those areas of insurance contract law which have given rise to particular concerns, or whether it would be more satisfactory to attempt to encapsulate all the relevant law in a statutory code.

3.2 A potential major advantage of a code is that it should be comprehensive and accessible, giving a single source for the law. This may be attractive in an area like insurance, where the law is currently fragmented and to be found in an array of statutes and cases dating back almost 250 years. A code should also offer more coherent law. The alternative — piecemeal reform — could make the law even less accessible, as yet another statute would have to be consulted. It would also run the risk that changes in one area of law have an unexpected consequence in another. Additionally, a modern code might be useful not just for domestic purposes, but also to influence our European partners in any future harmonisation initiative.

3.3 There are, however, disadvantages to a code. It would be time-consuming to prepare, which would delay reform where it is most needed. Potentially, it could remove an element of flexibility from the law. A code would not cover every circumstance, and it would inevitably become out-of-date.[1]

3.4 In early consultations we have discussed what areas should be covered by a code. We list here the main suggestions that have been made, showing in italics the topics which may need review and which were dealt with in Part 2:

[1] A set of papers giving the arguments for and against codes can be found in [2001] *Journal of Business Law* 569-622.

Definition of insurance *Insurable interest* Capacity *Non-disclosure* *Misrepresentation* Questions on the proposal form Waiver and estoppel *Agency* Form *Contract certainty* Payment of premiums Interpretation Incomplete or ambiguous terms Unfair or unusually onerous terms *Worthless policies* Basis of the contract clauses Promissory warranties Illegality Mistake	*Joint insureds* Claims Notification conditions Burden and standard of proof Indemnity Loss reduction measures Proximate cause Under-insurance Methods of settlement Contribution *Unjustifiable delay in settling claims* *Subrogation* Assignment Cancellation Renewals *Post-contractual utmost good faith* *Fraud* Dispute resolution Group policies

3.5 In our initial discussions there was some support for a CSB code, but little enthusiasm for such an approach being taken for MLBs. Accordingly, we have asked separate questions for the two categories of policyholders. We would be reluctant to undertake the preparation of either type of code if the result would be to delay reform of those aspects of the law where the need is most pressing. If there is to be a code, it will therefore be dealt with as a second phase to the project.

3.6 **Should we seek to produce a statutory code for insurance contract law as it applies to consumer and small business policyholders?**

3.7 **Should we seek to produce a statutory code for insurance contract law as it applies to medium and large business policyholders?**

PART 4
QUESTIONS

4.1 In this section we list the questions we have asked. You may find it convenient to photocopy the list or to download a response form from our website at http://www.lawcom.gov.uk/insurance_contract.htm.

4.2 For each area you feel should be reviewed, please indicate whether review is in your view a high, medium or low priority. Please feel free to give details of the reasoning behind your answers, using either the spaces provided or a separate sheet.

(1) Do you agree that insurable interest should be included in the review?

Yes/No/Don't Know
High/Medium/Low Priority

Your comments:

(2) Should we consider introducing a statutory definition of insurance?

Yes/No/Don't Know
High/Medium/Low Priority

Your comments:

(3) Do you agree we should consider the law of agency insofar as it relates to insurance?

Yes/No/Don't Know
High/Medium/Low Priority

Your comments:

(4) Do you agree we should consider the law of subrogation? Yes/No/Don't Know
High/Medium/Low Priority

Your comments:

(5) Do you agree we should consider the issue of "worthless" policies? Yes/No/Don't Know
High/Medium/Low Priority

Your comments:

(6) Do you agree that we should consider the position of joint insureds? Yes/No/Don't Know
High/Medium/Low Priority

Your comments:

(7) Should we consider the issue of contract certainty? Yes/No/Don't Know
High/Medium/Low Priority

Your comments:

(8)	Do you agree that we should review the post-contractual duty of good faith? Your comments:	Yes/No/Don't Know High/Medium/Low Priority
(9)	Do you agree we should review the law as it relates to fraud in the making of a claim, and the definition of fraud for this purpose? Your comments:	Yes/No/Don't Know High/Medium/Low Priority
(10)	Do you agree that section 22 of the Marine Insurance Act 1906 should be reviewed? Your comments:	Yes/No/Don't Know High/Medium/Low Priority
(11)	Do you agree that section 53 of the Marine Insurance Act 1906 should be reviewed? Your comments:	Yes/No/Don't Know High/Medium/Low Priority

(12) Do you agree that the Marine Insurance Act 1788 should be reviewed?

Yes/No/Don't Know
High/Medium/Low Priority

Your comments:

(13) Do you agree that section 83 of the Fires Prevention (Metropolis) Act 1774 should be reviewed?

Yes/No/Don't Know
High/Medium/Low Priority

Your comments:

(14) Are there other existing statutory provisions which should be reviewed with a view to amendment or repeal? If so, please give details.

Yes/No/Don't Know
High/Medium/Low Priority

Your comments:

(15) Do you agree we should we consider the remedies available to a policyholder when an insurer unjustifiably delays the settlement of a claim?

Yes/No/Don't Know
High/Medium/Low Priority

Your comments:

(16)	Do you agree that the review of general principles of insurance law should include their application to reinsurance? Your comments:	Yes/No/Don't Know High/Medium/Low Priority
(17)	What other areas of law would you like us to review? Please give brief reasons for your views. Your comments:	Yes/No/Don't Know High/Medium/Low Priority
(18)	Should we seek to produce a statutory code for insurance contract law as it applies to consumers and small business policyholders? Your comments:	Yes/No/Don't Know High/Medium/Low Priority

(19)	Should we seek to produce a statutory code for insurance contract law as it applies to medium and large business policyholders? Your comments:	Yes/No/Don't Know High/Medium/Low Priority

4.3 When responding it would be helpful if you would let us have your contact details, and some indication of the nature of your interest in insurance contract law.

Your name:

Email address:

Address:

Telephone number:

Nature of your interest in insurance contract law:

Organisation:

4.4 Responses may be sent:

By post to:
Peter Tyldesley
Law Commission
Conquest House
37-38 John Street
Theobalds Road
London
WC1N 2BQ

By email to: peter.tyldesley@lawcommission.gsi.gov.uk

Tel: 020 7453 1201

It would be helpful if, where possible, comments sent by post could also be sent on disk, or by email to the above address, in any commonly used format.

APPENDIX A
NON-DISCLOSURE, MISREPRESENTATION AND BREACH OF WARRANTY

A.1 In this part of the paper we give brief reasons why we have already decided to consider non-disclosure and breach of warranty.

NON-DISCLOSURE

A.2 Policies of insurance are within a special class of contracts known as contracts of the utmost good faith. As a result, when a policy of insurance is being negotiated, there is a duty on the applicant and the insurer to disclose — each to the other — all material facts. If either fails to disclose a material fact, and that failure induces the contract, the innocent party may on discovery of the non-disclosure avoid the policy — that is, set it aside from the outset. The duty of disclosure arises again when a policy is renewed, since in law a new contract is formed.

A.3 Behind the duty of disclosure lies the presumption that there is an inequality of knowledge as between insurer and applicant. The traditional view is that this imbalance is most likely to be significant in terms of the information that the applicant alone holds.

A.4 We have concluded that there is a sound case for including pre-contractual disclosure within the scope of the review. Six aspects of the law in this area cause us particular concern:

(1) The relative knowledge of insurer and applicant in modern circumstances.

(2) The test of materiality.

(3) The lack of obligation to ask questions.

(4) The “all-or-nothing” remedy.

(5) The lack of significant distinction in the consequences of innocent, negligent and fraudulent non-disclosure.

(6) The absence of a requirement of a causal link between any non-disclosure and a loss which occurs.

Further details of each of these issues are given below.

Inequality of knowledge

A.5 The original rationale behind the duty of disclosure is apparent from the early leading case of *Carter v Boehm*.[1]

> **Case Study 7**
> Carter, the Governor of Fort Marlborough on Sumatra, sent instructions to his brother in London to arrange insurance for him against the loss of this trading post. The instructions were dated 22 September 1759, but did not reach London until May 1760. A policy was issued for one year, commencing on 16 October 1759. Unknown to either Carter's brother or the underwriter, Boehm, Fort Marlborough had in fact fallen to the French on 1 April 1760. A dispute arose as to whether Carter should have disclosed his concerns regarding the state of Fort Marlborough, the likelihood of an attack from the French, and a letter warning of previous French designs on the location.
>
> Though finding that there had been disclosure, Lord Mansfield delivered a classic exposition of the duty of disclosure:
> *Insurance is a contract upon speculation. The special facts, upon which the contingent chance is to be computed, lie most commonly in the knowledge of the insured only: the underwriter trusts to his representation, and proceeds upon confidence that he does not keep back any circumstance in his knowledge, to mislead the under-writer into a belief that the circumstance does not exist, and to induce him to estimate the risque, as if it did not exist.*

A.6 In 1760, there was no swift means for Boehm to establish the current state of affairs in Sumatra. Modern means of communication — telephones, fax machines, email and the like — did not exist. It was a matter of months before written reports of events in Sumatra were received in London. An underwriter in the position of Boehm therefore had to rely to a significant degree on full disclosure by the applicant for insurance.

A.7 It is notable that Carter was found to have made full disclosure. The law has subsequently hardened in favour of insurers, and there must be some question as to whether the same decision would be reached today.

A.8 There is, of course, no doubt that some facts remain solely in the knowledge of applicants. However, it has been suggested that there is no longer such an imbalance of knowledge, especially where consumers are concerned. For example, an insurer may have a better knowledge of the incidence of burglary or flooding in an area than a consumer who has only recently moved there.

[1] *Carter v Boehm* (1766) 3 Burr 1905, 1909.

A.9 One consultee expressed particular concern that insurers may rely on the information provided by consumers when they know that potentially more accurate information is available elsewhere. For example, a life insurer may rely solely on the medical information provided by an applicant, rather than also obtaining a report from the applicant's general practitioner. Our consultee accepted that costs might be incurred in obtaining information, and that these costs would, at least in part, be passed on to policyholders generally. However, he suggested that such costs had to be balanced against the potential loss to a policyholder if the information was not obtained.

A.10 Particular mention was made of the Claims and Underwriting Exchange ("CUE"). CUE is a database of incidents reported to subscribing insurers by their policyholders, whether or not such incidents resulted in a claim. It includes details relating to various types of cover including motor and household insurance. Subscribing insurers can access the information held in CUE. In doing so, an insurer may be able to access a more accurate record than the applicant is able to provide from his memory. However, our consultee told us that some insurers consult CUE only when a claim is made. Issues of non-disclosure may then be raised. He criticised this approach as "underwriting at the claims stage".

Test of materiality

A.11 It was established in *Pan Atlantic v Pine Top*[2] that an applicant for insurance is obliged to disclose all facts that would have an effect — not necessarily decisive — on the mind of a prudent insurer in assessing the risk. We are concerned that this test is capable of giving rise to unfairness, particularly in the consumer context. A consumer is unlikely to have any knowledge of the requirements of a prudent underwriter. It is therefore possible for an applicant to act reasonably and honestly, yet still fail to meet the duty of disclosure.

A.12 Significantly, an exception to this rule exists. In Scotland, for life assurance only, the test of materiality is whether a reasonable man in the position of the assured, and with knowledge of the facts in dispute, should have realised they were material.[3]

No need to ask questions

A.13 The position is exacerbated by the fact that there is no obligation on an insurer to ask questions — even about matters which have been generally found to be material. There has been no change in the law since these issues were aired in the case of *Lambert v Co-operative Insurance* in 1975.

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

[3] *Life Association of Scotland v Foster* (1873) 11 M 351.

Case Study 8[4]

Mrs Lambert made a claim under a household policy that she and her husband had held for nine years. At the commencement of the policy and at each subsequent renewal, the insurer failed to ask whether Mr or Mrs Lambert had any criminal convictions. Nevertheless, when the claim was made, the insurer set the policy aside on the grounds that there had been a non-disclosure of convictions imposed on Mr Lambert.

Reluctantly, the Court of Appeal held that the insurer was entitled to act in this way:

The present case shows the unsatisfactory nature of the law. Mrs Lambert is unlikely to have thought that it was necessary to disclose the distressing fact of her husband's recent conviction when she was renewing the policy on her little store of jewellery. She is not an underwriter and has presumably no experience in these matters. The defendant company would act decently if, having established the point of principle, they were to pay her. It might be thought a heartless thing if they did not, but that is their business, not mine.

MacKenna J.

All-or-nothing remedy

A.14 Issues of non-disclosure are most commonly raised after a claim has been made. If the insurer is able to prove non-disclosure, its remedy is to avoid the policy from outset. Avoidance has serious consequences for the policyholder. Cover under the policy is lost, and the claim will be declined. Additionally, in future applications for insurance, the policyholder will have to disclose the fact that the policy was avoided. This may make it more difficult to obtain cover, or lead to higher premiums being charged.

A.15 In jurisdictions such as France the principle of proportionality may be applied. In simple terms, if a non-disclosure has led to a policyholder paying, say, fifty percent of the correct premium, then only fifty percent of the claim will be paid. The English Law Commission concluded in 1980 that such an approach would be unworkable. However, we believe that this conclusion needs to be reconsidered in light of the experience of the Ombudsmen. Since 1981, the Ombudsmen have successfully applied proportionality in appropriate cases.

[4] *Lambert v Co-operative Insurance Society Limited* [1975] 2 Lloyd's Rep 485, 491.

Innocence, negligence or fraud

A.16 An insurer is entitled to avoid a policy for non-disclosure regardless of whether the non-disclosure was fraudulent, negligent or innocent. We believe that it is appropriate to consider whether avoidance is a suitable remedy in all cases. In particular, we are concerned about innocent non-disclosure. As demonstrated by *Lambert v Co-operative Insurance Society Limited* it is possible for a policyholder to act reasonably and honestly, and yet still find the insurer has the right to avoid the policy. The risk faced by those completing application forms for insurance is well described by one academic:

> Applicants in England may complete the form with scrupulous care, but still find that there was something else material to prudent insurers which, apparently, the particular insurer did not think to ask about but which, nonetheless, the applicant was expected to think of and disclose.[5]

Causal link not required

A.17 An insurer also has the right in law to avoid a policy even if there is no link between the non-disclosure and any loss that has occurred. In such circumstances, avoidance may well appear a disproportionate response — particularly if the non-disclosure is innocent.

Case Study 9[6]

Mr and Mrs C held a critical illness insurance policy. When he arranged the policy, Mr C had failed to disclose that Mrs C had suffered a series of ear infections, leaving her with some loss of hearing. Just over a year after the policy was issued, Mrs C was diagnosed with leukaemia. Sadly, she died shortly after this diagnosis.

When Mr C made a claim under the policy, the insurer discovered the non-disclosure. There was clearly no link between the fact that had not been disclosed, and the loss that had occurred. If the insurer had known of Mrs C's ear problems, it would merely have insisted on an exclusion relating to her hearing. Nevertheless, it avoided the policy from outset, relying on the fact that the non-disclosure had induced it to issue a policy without such an exclusion.

The Ombudsman instructed the insurer to meet the claim in full. He concluded that the non-disclosure was innocent. Given that an exclusion relating to hearing would not have been relevant in a claim for leukaemia, he regarded the insurer's actions as unreasonable and disproportionate.

5 M A Clarke, *Policies and Perceptions of Insurance Law in the Twenty-First Century* (2005) p 103.

6 Financial Ombudsman Service, *Ombudsman News* (April 2003) Case 27/5.

Reciprocity

A.18 The duty of disclosure applies to the insurer as well as to the applicant for insurance. However, the potential benefit to the applicant is limited by two factors:

(1) The disclosure required from an insurer appears to be limited to facts which are material to the risk to be covered or to the recoverability of any claim. What would be required for true reciprocity? For example, an insurer is entitled to details of an applicant's claims history and criminal record. Should the applicant be entitled to the insurer's complaints record, or details of any regulatory intervention it has experienced?

(2) In most cases of non-disclosure by an insurer, a policyholder will not wish to avoid the policy. It is likely that the matter will have come to light following a loss suffered by the policyholder, and in those circumstances a mere return of premiums is unlikely to be adequate compensation.

A.19 Steyn J, as he then was, addressed both these factors in *Banque Financiere de la Cite SA v Westgate Insurance Co Ltd*.[7] He decided that the test that should be applied was whether "good faith and fair dealing require disclosure", and that a policyholder could claim damages. However, his decision on both points was reversed by the Court of Appeal.[8] In our view, it is now time to revisit this issue.

MISREPRESENTATION

A.20 Misrepresentation occurs where one of the parties provides false information to the other. It may be, for example, that an applicant for insurance answers a question on the application form incorrectly. At present, the distinction between misrepresentation and non-disclosure is not of general importance. The duty of disclosure is sufficiently wide that a misrepresentation will usually also amount in law to a non-disclosure. The two defences are therefore frequently raised together by insurers.

A.21 However, in English law there is potentially a difference in the remedies that can be granted by a court. Under section 2(2) of the Misrepresentation Act 1967, a court has a discretion to award damages in place of avoidance. There is some authority that this discretion will not be exercised in commercial cases:

[7] *Banque Financiere de la Cite SA v Westgate Insurance Co Ltd* [1987] 2 WLR 1300, 1330.

[8] *Banque Financiere de la Cite SA v Westgate Insurance Co Ltd* [1990] 1 QB 665.

> Where a contract of reinsurance has been validly avoided on the grounds of a material misrepresentation, it is difficult to conceive of circumstances in which it would be equitable within the meaning of s.2(2) to grant relief from such avoidance…. The rules governing material misrepresentation fulfil an important "policing" function in ensuring that the brokers make a fair representation to underwriters. If s.2(2) were to be regarded as conferring a discretion to grant relief on grounds of material misrepresentation the efficacy of those rules will be eroded. This policy consideration must militate against granting relief under s2(2) from an avoidance on the grounds of material misrepresentation in the case of commercial contracts of insurance.[9]

This seems to leave the door open to the discretion being exercised in consumer cases.

A.22 We have not yet reached any view as to how the law on non-disclosure should be reformed. The options will be discussed in our next consultation paper. It is, however, clear that some options might lead to greater significance attaching to the discretion to award damages for misrepresentation. For example, one suggestion already made to us is that in consumer cases the duty of disclosure should be abolished. A consumer's duties would be limited to answering honestly and carefully any questions asked by the insurer. The insurer might then find that even if there had been misrepresentation, a court would in appropriate circumstances award damages rather than allowing avoidance.

BREACH OF WARRANTY

A.23 Warranties are the most fundamental terms found in an insurance policy. They are in essence promises of past, present or future facts or of opinion. For example, a theft policy on commercial premises may include a warranty stating that an intruder alarm will be put into operation whenever the premises are closed for business. A breach of a warranty discharges the insurer from all liability from the time of the breach.

A.24 We have decided to include warranties within the scope of the review. Two aspects of the law in this area cause us particular concern — the lack of need for a causal connection between breach and any loss that has occurred, and the impact of "basis of the contract" clauses.

No need for a causal connection

A.25 An insurer is entitled to reject a claim for any loss suffered after a breach of warranty. There is, in law, no requirement for the insurer to show a connection between the breach and any loss that has occurred. Since cover ceases at the point of breach, the claim for any subsequent loss may be rejected, even where no causal link exists.

[9] *Highlands Insurance Co v Continental Insurance Co* [1987] 1 Lloyd's Rep 109, 118 by Steyn J.

Case Study 10[10]

Mr C had public liability insurance covering him for his work as a self-employed forestry consultant. His policy contained a warranty requiring him to notify the insurer immediately — in writing — of "any occurrence which may give rise to a claim". While Mr C was working on a large estate, a tree fell down and injured a third party. A few days later, Mr C heard that the third party was planning to claim against the estate owner for his injuries. Nearly 18 months after that, the estate owner's insurer told Mr C that it would be passing on to him the third party's injury claim. Mr C contacted his insurer immediately. The insurer refused to meet Mr C's claim on the grounds that he had breached the warranty.

Mr C referred the matter to the FOS. The Ombudsman concluded that the insurer's actions had not been fair or reasonable. It should not have expected Mr C to have realised at the time of the original incident that he was potentially liable. Given that Mr C was self-employed, and had no employees, the Ombudsman decided to apply the terms of the statement of general insurance practice, even though this was intended for use only in consumer cases. The statement of practice barred the insurer from rejecting a claim where the loss would still have occurred even if the warranty had been complied with, or where its position had not been prejudiced by the failure to comply. The insurer was therefore asked to deal with Mr C's claim.

Basis of the contract clauses

A.26 It is possible for an insurer to convert all the answers given on an application form into warranties. All that is required to achieve this result is the use of a particular form of words — such as a statement that the answers given will "form the basis of the contract".

A.27 The significance of such a statement is unlikely to be apparent to most CSBs. In fact, if an answer is incorrect, the applicant is effectively never insured — the breach of warranty brings the cover to an end immediately. The matter will frequently come to light when a claim is made. As a matter of law, the insurer is entitled to reject such a claim, even if there is no link between breach and loss.

A.28 In 1980, the English Law Commission drew attention to the scathing responses that the use of such clauses has drawn from the judiciary:

[10] Financial Ombudsman Service, *Ombudsman News* (August 2004) Case 39/2.

> I think it a mean and contemptible policy on the part of an insurance company that it should take the premiums and then refuse to pay upon a ground which no one says was really material. Here upon purely technical grounds, they, having in point of fact not been deceived in any material particular, avail themselves of what seems to me the contemptible defence that although they have taken the premiums, they are protected from paying.[11]

A.29 We believe that such criticism is still justified today, and that the use of such clauses should be reviewed. It is of particular concern that such clauses can currently be used in CSB contracts.

MARINE, AVIATION AND TRANSPORT

A.30 In 1980, the English Law Commission excluded marine, aviation and transport risks ("MAT") from the scope of its report. The reasons it gave for this decision were that the law was operating satisfactorily, and that it would be undesirable to disturb legal certainty in what is a very competitive international market.

A.31 The current review will include MAT. Criticism of some areas of the law — notably non-disclosure and breach of warranty — seems to us to be sufficiently fundamental to warrant review regardless of the type of risk. Furthermore, there is significant uncertainty around some of the most fundamental concepts in insurance contract law, as witnessed by the costly litigation that has occurred since 1980.

[11] *Glicksman v Lancashire & General Insurance Co* [1927] AC 139, 144 by Lord Wrenbury.

APPENDIX B
INSURABLE INTEREST

LIFE INSURANCE

B.1 The primary source of law is the Life Assurance Act 1774. Section 1 of the Act bans the making of insurances where there is no interest, and renders any policy issued in such circumstances null and void. It is clear from subsequent case law that such a policy is therefore illegal. Case law has also established that the interest need exist only at the time the policy is effected.

B.2 There are three classes of interest which satisfy the requirements of section 1 of the Act:

(1) Natural affection. One has an unlimited insurable interest in one's own life and that of one's spouse.

(2) Potential financial loss. There is an open class where one can insure a life in which one has a pecuniary interest, provided (in England and Wales) that one also has a legal or equitable interest.

(3) Statutory interest. Section 253 of the Civil Partnership Act 2004 gives each person in a civil partnership an insurable interest in the life of the other, and section 11 of the Married Women's Property Act 1882 confirms the right of a woman to insure her own life or that of her husband.

B.3 It has been suggested to us that the class of natural affection is too restricted. For example, the mere fact of cohabitation does not give cohabitees the right to insure the lives of their partners. Similarly, consultees felt that the test of potential loss was too demanding — in particular that unlike some other jurisdictions "a mere chance or expectation" is not sufficient.

MARINE INSURANCE

B.4 Under section 4 of the Marine Insurance Act 1906, a marine insurance policy is deemed to be a gaming contract and void unless it is entered into with an insurable interest or an expectation of acquiring such an interest. Section 5 of the Act provides that an insurable interest exists when a person "stands in any legal or equitable relation to the adventure or to any insurable property at risk therein". Policies effected without such interest are illegal under the Marine Insurance Act 1909.

B.5 Our attention has been drawn to the law in Bermuda, which we are told allows a variety of arrangements which would not be permissible in the UK. One example given was the "tonner" policy. The cover under a "tonner" relates to the tonnage of shipping losses in the policy year, rather than any loss directly suffered by the insured. Some consultees were in favour of relaxing the current law in the UK to allow such insurances; others felt very strongly that this would be undesirable.

BUILDINGS INSURANCE

B.6 For many years, it was believed that the Life Assurance Act 1774 applied not just to life insurance but to all insurances other than those excluded by section 4. For example, writing in 1885, Bunyon stated

> It has never been doubted but that this Act applies to fire insurance policies.[1]

This view continued even after the Act was given its short name in 1896.[2] As recently as 1963 the Court of Appeal suggested that the 1774 Act applied to fire insurance, though not as a binding part of its decision.[3]

B.7 Scots law may still take the view that the 1774 Act applies to buildings insurance. See, for example, *Arif v Excess Insurance Group*.[4] English law, in contrast, seems to be moving away from this stance. In 1985, the Court of Appeal accepted a submission that:

> This ancient statute was not intended to apply, and does not apply, to indemnity insurance, but only to insurances which provide for the payment of a specified sum on the happening of an insured event.[5]

This approach, which limits the impact of the Act to contingency insurances, was followed by the Privy Council in 1994 in a case involving employers' liability insurance. One key factor in the Privy Council's decision was that indemnity insurances appeared to be outside the mischief aimed at by the Act:

> By no stretch of the imagination could indemnity insurance be described as “a mischievous kind of gaming”.[6]

However, the position is still far from certain. One academic suggests that these decisions are “not wholly convincing”, and puts forward a strong argument that buildings insurance should still be regarded as within the 1774 Act.[7]

B.8 If buildings insurance is outside the terms of the 1774 Act, a requirement of insurable interest may nevertheless be imposed by common law. An early English decision is that of *The Sadlers' Co v Badcock*, where the Lord Chancellor held:

> It is necessary the party insured, should have an interest or property at the time of insuring, and at the time the fire happens.[8]

1 C J Bunyon, *The Law of Fire Insurance* (3rd ed 1885) p 7.

2 Short Titles Act 1896.

3 *Re King* [1963] 1 Ch 459, 485 by Lord Denning.

4 1987 SLT 473.

5 *Mark Rowlands Ltd v Berni Inns Ltd* [1986] 1 QB 211, 227, by Kerr LJ.

6 *Siu Yin Kwan and another v Eastern Insurance Co Ltd* [1994] 2 AC 119, 211, by Lord Lloyd.

7 J Birds, *Bird's Modern Insurance Law* (6th ed 2004) p 50.

8 *Sadlers' Co v Badcock* (1743) 2 Atk 554.

Likewise, in Scotland the common law, as enunciated by Bell, would be sufficient authority for the need to show insurable interest.[9]

B.9 In England, writers commonly also refer to section 18 of the Gaming Act 1845, under which policies effected without a recognised interest are unenforceable as wagering contracts. Within the next two years, it is anticipated that section 18 of the Gaming Act 1845 will be repealed by the Gambling Act 2005.[10] It has been suggested that there is no evidence that the insurance implications of the repeal of the 1845 Act were intended or even foreseen, and that this provides a further reason for us to review the area.

[9] Bell, *Principles*, s 457.

[10] See J Davey, "The reform of gambling and the future of insurance law" [2004] *Legal Studies* 507.

APPENDIX C
POSSIBLE REPEALS

MARINE INSURANCE ACT 1906, SECTION 22

C.1 Subject to the provisions of any statute, a contract of marine insurance is inadmissible in evidence unless it is embodied in a marine policy in accordance with this Act. The policy may be executed and issued either at the time when the contract is concluded, or afterwards.

MARINE INSURANCE ACT 1906, SECTION 53

C.2 (1) Unless otherwise agreed, where a marine policy is effected on behalf of the assured by a broker, the broker is directly responsible to the insurer for the premium, and the insurer is directly responsible to the assured for the amount which may be payable in respect of losses, or in respect of returnable premium. (2) Unless otherwise agreed, the broker has, as against the assured, a lien upon the policy for the amount of the premium and his charges in respect of effecting the policy; and, where he has dealt with the person who employs him as a principal, he has also a lien on the policy in respect of any balance on any insurance account which may be due to him from such person, unless when the debt was incurred he had reason to believe that such person was only an agent.

MARINE INSURANCE ACT 1788

C.3 It shall not be lawful for any Person or Persons to make or effect, or cause to be made or effected, any Policy or Policies of Assurance upon any Ship or Ships, Vessel or Vessels, or upon any Goods, Merchandises, Effects, or other Property whatsoever, without first inserting, or causing to be inserted, in such Policy or Policies of Assurance, the Name or Names of the usual Stile and Firm of Dealing of one or more of the Persons interested in such Assurance; or without, instead thereof, first inserting, or causing to be inserted in such Policy or Policies of Assurance, the Name or Names, or the usual Stile and Firm of Dealing of the Consignor or Consignors, Consignee or Consignees of the Goods, Merchandises Effects or Property so to be insured; or the Name or Names, or the usual Stile and Firm of Dealing of the Person or Persons residing in Great Britain, who shall receive the Order for and effect such Policy or Policies of Assurance or of the Person or Persons who shall give the Order or Direction to the Agent or Agents immediately employed to negotiate or effect such Policy or Policies of Assurance. And be it further enacted by the Authority aforesaid, That every Policy and Policies of Assurance, made or underwrote contrary to the true Intent and Meaning of this Act, shall be null and void to all Intents and Purposes whatsover.

FIRES PREVENTION (METROPOLIS) ACT 1774, SECTION 83

C.4 And in order to deter and hinder ill-minded persons from wilfully setting their house or houses or other buildings on fire with a view of gaining to themselves the insurance money, whereby the lives and fortunes of many families may be lost or endangered: it shall and may be lawful to and for the respective governors or directors of the several insurance offices for insuring houses or other buildings against loss by fire, and they are hereby authorised and required, upon the request of any person or persons interested in or intitled unto any house or houses or other buildings which may hereafter be burnt down, demolished or damaged by fire, or upon any grounds of suspicion that the owner or owners, occupier or occupiers, or other person or persons who shall have insured such house or houses or other buildings have been guilty of fraud, or of wilfully setting their house or houses or other buildings on fire, to cause the insurance money to be laid out and expended, as far as the same will go, towards rebuilding, reinstating or repairing such house or houses or other buildings so burnt down, demolished or damaged by fire, unless the party or parties claiming such insurance money shall, within sixty days next after his, her or their claim is adjusted, give a sufficient security to the governors or directors of the insurance office where such house or houses or other buildings are insured, that the same insurance money shall be laid out and expended as aforesaid, or unless the said insurance money shall be in that time settled and disposed of to and amongst all the contending parties, to the satisfaction and approbation of such governors or directors of such insurance office respectively.