The Law Commission
Consultation Paper No 204
and
The Scottish Law Commission
Discussion Paper No 155

INSURANCE CONTRACT LAW:

THE BUSINESS INSURED'S DUTY OF DISCLOSURE AND THE LAW OF WARRANTIES

A Joint Consultation Paper

This is the third consultation paper in the joint insurance law project

THE LAW COMMISSIONS: HOW WE CONSULT

About the Commissions: The Law Commission and the Scottish Law Commission were set up by section 1 of the Law Commissions Act 1965 for the purpose of promoting the reform of the law.

- The Law Commissioners are: The Rt Hon Lord Justice Munby (*Chairman)*, Professor Elizabeth Cooke, Mr David Hertzell, Professor David Ormerod and Frances Patterson QC. The Chief Executive is Elaine Lorimer.
- The Scottish Law Commissioners are: Laura J Dunlop QC, Patrick Layden QC TD, Professor Hector L MacQueen and Dr Andrew J M Steven. The Chief Executive is Malcolm McMillan.

Topic: This Consultation covers two areas of insurance contract law: the business policyholder's duty to give pre-contract information to an insurer and the law of warranties.

Geographical scope: England and Wales, Scotland.

An impact assessment is available on our websites, and is summarised in Part 17.

Previous engagement: Our first consultation, in 2007, considered misrepresentation, non-disclosure and breach of warranty. Subsequently we published an Issues Paper on microbusinesses. In 2011 we published a Consultation Paper on Post Contract Duties and other Issues. They are to be found on our websites, together with other insurance project documents.

Duration of the consultation: 26 June 2012 to **26 September 2012**.

How to respond
Send your responses either –

By email to: commercialandcommon@lawcommission.gsi.gov.uk or

By post to: Christina Sparks, Law Commission,
Steel House, 11 Tothill Street, London SW1H 9LJ
Tel: 020 3334 0285 / Fax: 020 3334 0201

If you send your comments by post, it would be helpful if, where possible, you also sent them to us electronically (in any commonly used format).

After the consultation: We plan to publish final recommendations in 2013 and present them to Parliament. It will be for Parliament to decide whether to change the law.

Freedom of information: We will treat all responses as public documents. We may attribute comments and publish a list of respondents' names. If you wish to submit a confidential response, it is important to read our Freedom of Information Statement on the next page.

Availability: You can download this consultation paper and the other documents free of charge from our websites at: http://www.lawcom.gov.uk (See A–Z of projects > Insurance Contract Law) and http://www.scotlawcom.gov.uk (See News column).

CODE OF PRACTICE ON CONSULTATION

The Law Commission is a signatory to the Government's Code of Practice described below.

THE SEVEN CONSULTATION CRITERIA

Criterion 1: When to consult
Formal consultation should take place at a stage when there is scope to influence the policy outcome.

Criterion 2: Duration of consultation exercise
Consultations should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible.

Criterion 3: Clarity and scope of impact
Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.

Criterion 4: Accessibility of consultation exercises
Consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.

Criterion 5: The burden of consultation
Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.

Criterion 6: Responsiveness of consultation exercises
Consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.

Criterion 7: Capacity to consult
Officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.

CONSULTATION CO-ORDINATOR

The Law Commission's Consultation Co-ordinator is Phil Hodgson. You are invited to send comments to the Consultation Co-ordinator about the extent to which the criteria have been observed and any ways of improving the consultation process.

Contact: Phil Hodgson, Law Commission, Steel House, 11 Tothill Street, London SW1H 9LJ
Email: phil.hodgson@lawcommission.gsi.gov.uk

Full details of the Government's Code of Practice on Consultation are available on the BIS website at http://www.bis.gov.uk/policies/better-regulation/consultation-guidance.

Freedom of Information statement

Information provided in response to this consultation, including personal information, may be subject to publication or disclosure in accordance with the access to information regimes (such as the Freedom of Information Act 2000, the Freedom of Information (Scotland) Act 2002 and the Data Protection Act 1998 (DPA)).

If you want information that you provide to be treated as confidential, please explain to us why you regard the information as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Law Commissions.

The Law Commissions will process your personal data in accordance with the DPA and in most circumstances this will mean that your personal data will not be disclosed to third parties.

THE LAW COMMISSION

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INSURANCE CONTRACT LAW: THE BUSINESS INSURED'S DUTY OF DISCLOSURE AND THE LAW OF WARRANTIES

CONTENTS

CHAPTER 2: THE LAW OF WARRANTIES

TABLE OF ABBREVIATIONS

The 1906 Act	Marine Insurance Act 1906
The 2012 Act	The Consumer Insurance (Disclosure and Representations) Act 2012
ABI	Association of British Insurers
Airmic	The risk managers' association
ALRC	Australian Law Reform Commission
BIBA	British Insurance Brokers' Association
BILA	British Insurance Law Association
FOS	Financial Ombudsman Service
FSA	Financial Services Authority
FSMA	Financial Services and Markets Act 2000
ICOBS	Insurance Conduct of Business Sourcebook
IUA	International Underwriting Association
LMA	Lloyd's Market Association
NZLRC	New Zealand Law Reform Commission
PEICL	Principles of European Insurance Contract Law
VAG	The Versicherungsaufsichtsgesetz or German Insurance Supervision Code
VVG	The Versicherungsvertragsgesetz or German Insurance Contract Law Code
UTCCR	Unfair Terms in Consumer Contracts Regulations 1999

All websites referenced in this document were valid as at 2 May 2012.

GLOSSARY OF TERMS AND MAIN TEXTS

GLOSSARY OF TERMS

Assured/insured	Another name for a policyholder.
Broker	An individual or firm who arranges the sale or purchase of insurance.
Business angel	Individuals or groups who invest equity capital in unlisted businesses.
Casualty	A loss, particularly that of a ship.
Cover	Insurance or reinsurance of one or more risks.
Data dumping	Where a proposer gives an insurer a large amount of undigested information for the insurer to sort through and decide what's relevant.
Demurrage	Damages, usually liquidated, for delay payable by the charterer of a ship; for example for delay in loading or unloading the ship.
Hard market	Where the demand for insurance outstrips the supply. This can result in higher premiums or less extensive cover being offered.
Insurance intermediary	Someone through whom insurance is bought or sold, usually a broker.
Personal lines	Insurance cover for individual consumers, such as buildings and contents insurance, personal injury insurance or motor insurance.
Placing broker	A broker who places insurance cover on behalf of its client with an underwriter.
Policyholder	The person insured under an insurance contract.
Premium	The price charged by the insurer in return for providing insurance cover.
Producing broker	A broker who introduces a proposal for insurance or reinsurance to its own broking firm or another broking firm.
Proposal form	A standard form usually produced by the insurer which asks for information about the proposer. The insurer bases its decision of whether and on what terms to offer cover on the information provided.
Proposer	The party seeking insurance.

Reinsurance	Insurance purchased by one insurer from another insurer to cover losses it might incur in relation to claims made by its policyholders.
Retrocession	The reinsurance of a reinsurer by another reinsurer.
Soft market	Where the availability of insurance outstrips the demand. This can result in lower premiums or an offer of more extensive cover.
Special purpose vehicle	Also called a special enterprise vehicle. A company created solely for a particular transaction or transactions.
Underwriting	The process by which an underwriter evaluates and assesses the risk for which cover is sought and decides whether to offer cover, on what terms and at what price.
Wharfinger	An ancient name for a person who is owner or keeper of a wharf.
White labelling	Where insurance is marketed under the name of the agent.

MAIN TEXTS

Arnould	Arnould's Law of Marine Insurance and Average (17th ed 2008)
Birds	Bird's Modern Insurance Law (8th ed 2010)
Clarke	The Law of Insurance Contracts
Colinvaux	Colinvaux & Merkin's Insurance Contract Law
MacGillivray	MacGillivray on Insurance (11th ed 2008)
MacQueen and Thomson	Contract Law in Scotland (2nd ed 2007)
McBryde	The Law of Contract in Scotland (3rd ed 2007)
O'Neill and Woloniecki	The Law of Reinsurance (3rd ed 2010)
Reid & Blackie	Personal Bar (2006)

PREFACE

1.1 This is the third, and final, Consultation Paper in the English and Scottish Law Commissions' joint review of insurance contract law. It deals with two issues:

(1) Chapter 1 considers a business policyholder's duty to give pre-contract information to an insurer, as set out in sections 18 to 20 of the Marine Insurance Act 1906.

(2) Chapter 2 considers the law of warranties.

1.2 The final chapter, Chapter 3, considers the impact of the reforms and lists the questions and proposals.

1.3 A summary of this Paper is available on our websites at www.lawcom.gov.uk and www.scotlawcom.gov.uk. We are also publishing a separate impact assessment of our proposals on our websites.

HOW TO RESPOND

1.4 We are seeking responses by **26 September 2012**

Please send responses either –
By email to: commercialandcommon@lawcommission.gsi.gov.uk or
By post to: Christina Sparks, Law Commission, Steel House, 11 Tothill Street, London, SW1H 9LJ
Tel: 020 3334 0285 / Fax: 020 3334 0201

Responses forms available at: http://www.lawcom.gov.uk (A-Z of projects >Insurance Contract Law) and http://www.scotlawcom.gov.uk (See News column)

PREVIOUS PUBLICATIONS

1.5 We first discussed these matters in our 2007 Consultation Paper, *Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured*.[1] In 2007 we considered how the duty of disclosure applied to both consumers and to businesses. Responses showed a strong consensus in favour of reform for consumers. We therefore announced that we would draft legislation to reform the law of disclosure and misrepresentation in consumer insurance as a matter of priority.

1.6 In 2009, we published a final Report and draft Bill on this aspect of consumer insurance law. In May 2011, the Consumer Insurance (Disclosure and Representations) Bill was introduced in the House of Lords, through the special procedure for uncontroversial Law Commission Bills. It received Royal Assent in March 2012 and we hope that it will be brought into force next spring.

[1] Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured; (2007) LCCP 182/SLCDP 134.

1.7 In December 2011, we published a second Consultation Paper[2] which considered four other issues in insurance contract law: damages for late payment; insurers' remedies for fraudulent claims; insurable interest; and policies and premiums in marine insurance. We received 52 responses, which we are now analysing.

THIS PAPER

1.8 Although there was consensus on consumer insurance law, there was much less agreement on our proposals to reform the duty of disclosure in business insurance or to reform the law of warranties. We are therefore taking the unusual step of consulting on these issues again. The law in these areas is a major concern to both insurers and policyholders. It is crucial that any reform is based on a practical understanding of how change would work in practice.

1.9 We received a wide and thorough response to our first Consultation Paper. In October 2008, we published a summary of responses in so far as they considered business insurance.[3]

1.10 Most of those who responded to our business proposals favoured reform, but there was disagreement on the way forward. As a result of the consultation response and the subsequent discussions we have had with companies and organisations across the market, we have significantly altered our original views. We therefore believe that the most sensible course of action is to consult again.

THE PROBLEMS OF CODIFICATION

1.11 The modern law of insurance contracts arose in the eighteenth century, was developed by the courts in the nineteenth century and codified in the Marine Insurance Act 1906. Although the Act only appears to relate to marine insurance, most of its principles have been taken to apply to all insurance on the basis that it embodies the common law.

1.12 When Lord Mansfield first developed the principle of good faith, the insurance market was a small group of individuals based in London. The insurance market has grown substantially since then. In 1779, Lloyds had 179 members; by 1988, it had 33,552.[4] In 1994, Lloyds opened its doors to corporate members and they now dominate the market place.[5] This growth has meant that a market based on face to face contact and social bonds has developed into one based on systems, procedures and sophisticated data analysis.[6]

2 Insurance Contract Law: Post Contract Duties and other Issues; (2011) LCCP 201/SLCDP 152.

3 Reforming Insurance Contract Law: A summary of responses to consultation (Oct 2008).

4 For a discussion of how the size of Lloyds has fluctuated over the years see O'Neill and Woloniecki; *The Law of Reinsurance*, (3rd ed 2010) at para 2-011 and following. See also http://www.lloyds.com/The-Market/Tools-and-Resources/Resources/Statistics-Relating-to-Lloyds

5 In 2011 Lloyds had 1,529 corporate members and 637 names, see http://www.lloyds.com/The-Market/Tools-and-Resources/Resources/Statistics-Relating-to-Lloyds.

6 In *Daly v Lime Street Underwriting Agencies* [1987] 2 FTLR 277, Staughton J commented:

1.13 In many ways it is unfortunate that primary legislation was used to codify the commercial practices of a relatively small and specialist market in London. It was doubly unfortunate that the courts applied these rules to all forms of insurance. It has made it difficult for the law to develop as the market has expanded the types of risks insured. Although recent cases have glossed the law to accommodate contemporary conditions,[7] the clear words of the 1906 Act continue to exert a strong gravitational pull. There are still many instances where the courts are prepared to interpret the words of the Act strictly,[8] even if those words embody social and economic attitudes from a previous era.

1.14 Codification is a one-way street. Once the law has been codified we have no way of de-codifying it. Codes can only be changed by Parliament: any revision to the Marine Insurance Act 1906 requires further legislation. This Paper is therefore focused on statutory reform.

NEXT STEPS

1.15 Our aim is to publish a final report and draft Bill by the end of 2013. This will draw together recommendations from both the 2011 Consultation Paper and this Consultation Paper, with a view to amending the Marine Insurance Act 1906 and the common law which underpins it.

THANKS

1.16 In this Consultation Paper we draw heavily on the responses we received to our 2007 Consultation Paper and subsequent Issues Papers. We would like to thank all those who took such time and trouble to send us their views. We are particularly grateful to all those who met us to discuss our developing thinking in this area.

1.17 We have also been helped by accounts of how the duty of disclosure works in practice. In this paper we draw on the reports of the Mactavish Group, who are a research and consultancy business specialising in risk and insurance. We also thank Airmic, the British Insurance Brokers' Association and the Association of British Insurers for sharing their survey data with us.

1.18 Finally, special thanks are due to David W Kenna and Mound Cotton Wollan & Greengrass, who have provided us with a paper on how disclosure issues are dealt with under New York law. The paper is quoted in Part 3, and is available in full on our website at http://www.lawcom.gov.uk (See A-Z of projects>Insurance Contract Law) and http://www.scotlawcom.gov.uk.

> "When Mr Lloyd ran his coffee-house at the start of the 18th century such elaborate arrangements may not have been necessary. For all I know each underwriter then used to attend daily, to subscribe personally to contracts of insurance, receive premiums and pay claims. But with over 30,000 members it is plain that agency is an essential feature of the operation in modern times."

[7] For example, in *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd*, [1995] 1 AC 501; [1994] 2 Lloyd's Rep 427, the House of Lords held that an insurer may only avoid the contract if it can show that it was induced by the misrepresentation to enter into the policy on the relevant terms. See further Part 5, para 5.61 and following..

[8] See discussion of *Sugar Hut* v *Great Lakes Reinsurance (UK) Ltd* [2010] EWHC 2636 at Part 12, para 2.51 and following.

CHAPTER 1

THE BUSINESS INSURED'S DUTY OF DISCLOSURE

PART 1
DISCLOSURE: INTRODUCTION

THE DUTY OF DISCLOSURE

1.1 The Marine Insurance Act 1906 (the 1906 Act) places an onerous duty on prospective policyholders to disclose information to an insurer before concluding a contract. Section 18(1) states that the policyholder must disclose "every material circumstance" which he knows or ought to know "in the ordinary course of business". If not, the insurer may avoid the policy. In other words, the insurer may treat the policy as if it does not exist and refuse all claims under it.

1.2 A material circumstance is defined in section 18(2) of the 1906 Act as "every circumstance which would influence the judgment of a prudent insurer in fixing the premium, or determining whether he will take the risk".

1.3 Good disclosure requires co-operation between both parties. The policyholder knows how the business is run; the insurer knows which facts are relevant to assessing the risk. Our starting point is that the policyholder should make a fair presentation of the risk, and the insurer should ask appropriate questions.

1.4 The problem is that the duty set out in section 18 appears unduly wide. The policyholder is required to look into the mind of a hypothetical prudent insurer and work out what would influence it. Businesses find it difficult to know what facts to focus on, or how to gather appropriate information from within a complex organisation.

1.5 Meanwhile the wording of section 18 appears to suggest that the insurer may play an entirely passive role, without asking questions or indicating what it wishes to know. Instead, the section encourages a practice of "underwriting at claims stage", whereby an insurer may take a risk, however inadequately presented, and ask questions only if a claim arises.

1.6 These problems are compounded by the fact that the only remedy for non-disclosure is avoidance of the contract. A policyholder who acts in good faith, but who fails to mention a minor issue, risks losing all benefit from the policy, even if the insurer would only have added a small amount to the premium had it known the true facts.

THE DUTY OF DISCLOSURE IN PRACTICE

Which businesses experience problems?

1.7 Originally, we had assumed that the burden of disclosure would fall disproportionately on small businesses. In fact we have received considerable evidence that larger businesses experience even greater problems with disclosure. The Mactavish Report[1] suggests that the greatest problems are experienced by businesses with a turnover of between £50 million and £5 billion.[2]

1.8 Small businesses are usually asked specific questions, which makes the disclosure process less onerous. By contrast, large businesses are expected to present the risk, without insurers asking questions or indicating what they wish to know. The risk managers' association (Airmic) has a membership of nearly 1,000 and represents the insurance buyers and claims handlers for about 75% of the FTSE 100 companies. [3] It points out that multi-national businesses are now so complex that few can be sure they have assembled all the requisite information and told insurers everything they would want to know.

1.9 We summarise the evidence of problems in Part 4. Section 18 of the 1906 Act generates a high volume of disputes and litigation: according to an Airmic survey in 2010,[4] a third of their members had experienced a dispute over non-disclosure issues in the last five years, and one in twenty had been involved in litigation on the issue. Although most cases settle, many proceed to court. We have identified 41 reported judgments on section 18 in the last 10 years.[5]

Micro-businesses

1.10 In response to our 2007 Consultation Paper,[6] some respondents suggested that additional protections should be provided to the smallest businesses, that is, those with fewer than 10 employees.[7]

1.11 It was suggested that micro-businesses should have the same protections as consumers. We can see the logic of this suggestion: the individual who buys private motor insurance could be the same person that buys insurance for a business van. Why should the applicable law differ?

[1] Corporate Risk & Insurance - The Case for Placement Reform. The Mactavish Protocols (2011). Mactavish is a research and advisory business specialising in the analysis of commercial risk, insurance policy reliability and insurance governance. The Report is the second part of a programme of research by Mactavish and draws on over 100 consultations with senior personnel in insurers, brokers and relevant service providers, 624 customer consultations and direct analysis of placement information.

[2] For a summary of the Mactavish Report, see Part 4 at paras 4.29 to 4.48.

[3] Until June 2010 the association was known as AIRMIC.

[4] AIRMIC Non-disclosure of material information – Member Survey (2010).

[5] Between January 2002 and January 2012. The 41 judgments, which include a small number of appeals in the same case, relate to 33 cases. The figure is made up of 26 English High Court cases, 12 Court of Appeal cases and 3 Scottish Court of Session cases.

[6] Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured; (2007) LCCP 182/SLCDP 134.

[7] 57 consultees gave their views of which 15 thought there was a need to provide further protection for small businesses.

1.12 We consulted on the point in Issues Paper 5.[8] Following extensive investigations we are no longer proceeding with this proposal. We set out the reasons for this decision in Appendix A. In summary:

(1) It was extremely difficult to produce a clear definition of a micro-business which could apply at the time the contract was formed. Reluctantly, we reached the conclusion that the Financial Ombudsman Service (FOS) definition, based on European Recommendation 2003/361, was too complicated for most small businesses to understand when they took out insurance.

(2) Insurers were concerned that they would need to ask additional questions and re-programme their systems to distinguish between micro-businesses and others. This would impose additional costs.

(3) There was little real evidence of a problem. We consulted small business representatives, insurers, the FOS, individual brokers and the British Insurance Brokers' Association (BIBA). BIBA also provided us with a helpful survey of their members' experience. Most of the problems identified related to policy wording rather than disclosure.

(4) In cases of hardship, the FOS is already able to provide protection to micro-businesses.

1.13 We have therefore concluded that while there might appear to be a logical case to distinguish small businesses, there is insufficient evidence of a systemic problem in practice to justify imposing a third regime for micro-businesses.

1.14 Under our current proposals, a micro business would still be subject to a duty of disclosure. In other words, when presented with a proposal form, the business would not simply be required to answer the questions, but would also expected to mention any special or unusual circumstances not covered by the questions. In this respect, we are not proposing to change the current law. Micro-businesses, would, however, benefit from the proposed new compensatory remedies, described below, as would small, medium and large enterprises.

1.15 In Issues Paper 3,[9] we suggested that small businesses may also need new rules to determine whether an agent acts for the insurer or the policyholder.[10] As we explain in Appendix A, we have now reached the conclusion that such rules are unnecessary. Where a small business uses a broker, the broker usually acts for it, in the same way as a broker acts for larger businesses. For consumers, special rules are included in schedule 2 of the Consumer Insurance (Disclosure and Representations) Act 2012, but we do not propose similar rules in the business market.

[8] Issues Paper 5: Micro-Businesses. Should micro-businesses be treated like consumers for the purposes of pre-contractual information and unfair terms? (April 2009).

[9] Issues Paper 3: Intermediaries and Pre-contract Information (March 2007).

[10] Above, para 7.2 to 7.8.

Reform for all business insurance

1.16 The proposals we make in this paper are aimed at all business insurance. This includes large risks, marine insurance and reinsurance.

1.17 Some of our recommendations for the consumer market were designed to "protect" consumers. This is not the aim of the proposals in this paper. We do not intend to produce a law which would protect businesses. Instead, we are seeking a "neutral" law that strikes a balance between the parties and which will impose reciprocal obligations on each. As we will see in Part 3, by international standards, the law of the UK is insurer-friendly. Our intention is to produce a more balanced system, with greater clarity for both policyholder and insurer.

1.18 We have received considerable evidence that the current law does not work as well as it should. Businesses are uncertain about their duties; insurers do not always do enough to encourage effective disclosure; and the "all or nothing" remedy of avoidance places the parties in a position of adversarial conflict.

1.19 This introduces friction into the system: it fosters too many disputes. Even for cases which do not proceed to court, disputes cause delays and expense. If businesses do not properly outline the risk to the insurer in the proposal, then the risk may be underpriced, and the claim may not be paid. This can affect the viability of a business, whether large or small. It is not only a problem for the business concerned, but may have consequences for employees, creditors and the economy as a whole.

OUR PROPOSALS

The 2007 proposal: a reasonable insured test

1.20 In 2007, we proposed to replace the definition of "material circumstance" in section 18(2) of the 1906 Act. Instead of a test based on what would influence a prudent insurer, we proposed a test based on what a "reasonable insured" would think was relevant to the insurer.[11] The proposal received a mixed response. Although half of respondents supported the new test this was sometimes qualified and many criticised it for being uncertain.

1.21 We accept that a "reasonable insured" test would introduce an unknown and untested concept into the law. It would take judges time to develop a consistent approach, and during this time it would be even more difficult to advise businesses about what they were expected to disclose.

[11] Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured; (2007) LCCP 182/SLCDP 134, at paras 5.83 and 12.31.

An evolutionary approach

1.22 In this paper we take a more evolutionary approach, based on principles within the current case law. The high volume of disputes gives rise to a considerable body of case law on section 18 of the 1906 Act. In some cases, the courts have restricted the ambit of the duty of disclosure. For example, the courts have stressed that the policyholder should make a fair presentation of the risk. If this would prompt a reasonable insurer to make further enquiries these should be made. Where the insurer fails to make those enquiries, then the insurer cannot avoid the policy for a failure on the policyholder's part to provide information which those enquiries would have revealed.[12]

1.23 Although many cases set out helpful glosses on the nature of section 18 of the 1906 Act, most have been decided on specific facts after the event and with the aim of doing justice in that particular case. Although the case law may not have completely clarified what the duty of disclosure means in practical terms for a risk manager with the job of placing insurance on behalf of a business, we believe that it is possible to distil general principles of what amounts to good practice. We think, therefore, that there is much to be said for incorporating those judicial developments into the statute itself.

1.24 We see our proposals as providing a framework of principles. In order to provide the industry with transparency as to what is required, however, insurers and businesses need to work together to provide further guidance, protocols and understandings on how businesses should prepare presentations. The guidance needs to cover both procedural issues (how a business should set about preparing a presentation) and substantive issues (what must be included). We are pleased to note some initiatives along these lines have already started. We hope our reforms will stimulate further steps.

A fair presentation of the risk

1.25 In Part 5, we emphasise that the policyholder should volunteer essential information, so as to make a fair presentation of the risk. This should include any unusual or special circumstances which increase the risk; any particular concerns about the risk which led to the insurance being sought; and standard information which market participants generally understand should be disclosed.

1.26 If the presentation of the risk suggests potential problems, the onus should then be on the insurer to ask further questions. If the insurer receives information which would prompt a reasonably careful insurer to make further inquiries, it should not have a remedy for any non-disclosure which those enquires would have revealed.

1.27 These principles are already found within the current case law, but we think they need to be more widely known. We propose to include them within the statute.

[12] See *WISE Underwriting Agency Ltd v Grupo Nacional Provincial SA* [2004] EWCA Civ 962; and see the discussion at Part 5, para 5.38 and following.

The inducement test

1.28 The courts have added a new test to section 18 of the 1906 Act. The insurer must show that without the non-disclosure or misrepresentation it would not have entered into the contact at all, or only on different terms. In Part 5, we propose to include this test within the legislation.

The policyholder's knowledge under section 18

1.29 In practice large businesses often find it difficult to establish how to gather the relevant "knowledge" from within an organisation.

1.30 Section 18(1) of the 1906 Act states that disclosure includes:

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

There is considerable uncertainty over what these words mean, with leading textbooks taking differing views.[13]

1.31 In Part 6, we draw on the case law to conclude that where a business policyholder is a corporate entity, "knowledge" should include information known both to "the directing mind and will of the organisation" and to the persons who arranged the insurance on behalf of the organisation. In addition a business policyholder should be under a duty to disclose information that would have been discovered by reasonable enquiries, which are proportionate to the type of insurance and to the size, nature and complexity of the business.

1.32 Again, we think it would be helpful to provide a fuller definition of what a corporate policyholder "knows or ought to know" in the statute itself.

The policyholder's knowledge under section 20

1.33 In Part 6, we briefly discuss the knowledge test under section 20 of the 1906 Act. Section 20 imposes a duty on the policyholder that every material representation made to the insurer "must be true". The section distinguishes between representations of fact which to be true must be "substantially correct" and representations of expectation or belief which are treated as true if made in good faith. We think that in practice the courts will find issues which the policyholder knew or ought to know about to be matters of fact. Other issues are likely to be matters of expectation or belief.

1.34 We think it would be simpler and easier to apply the same knowledge test to both sections. We propose to amend section 20 of the 1906 Act to state that if a representation is one which the policyholder knew or ought to have known about (as defined in section 18 of the 1906 Act) then it must be true. If not, it must be made in good faith.

[13] See further Part 6.

The broker's knowledge under section 19

1.35 Under section 19 of the 1906 Act, where the policyholder uses a broker or other agent to effect insurance, the agent is also required to disclose information to the insurer.

1.36 Section 19 appears to place a duty on the broker to the insurer, but this is misleading. The only remedy for breach of the section is that the insurer may avoid its contract with the policyholder. The effect of section 19, therefore, is to extend the policyholder's duty to the insurer, not only to disclose information which the policyholder knows or ought to know, but also to disclose some additional circumstances which are known only to the broker.

1.37 The law on section 19 is confused, with several contrary judicial statements about what it covers. We think that there is a need to clarify what the policyholder's agent "knows" or "ought to know" in this context.

1.38 We propose that the duty of disclosure should include not only information known by the employee placing the insurance but also any information received or held by the agent in the course of acting for the policyholder. This should apply to all brokers in the chain. On the other hand, we propose to clarify that the duty does not include information given to the broker by other clients.

The insurer's knowledge under section 18(3)(b)

1.39 Section 18(3) of the Marine Insurance Act 1906 lists circumstances which the policyholder does not need to disclose. Under section 18(3)(b) the policyholder need not disclose "any circumstance which is known or presumed to be known to the insurer". This covers matters of "common notoriety and knowledge" and matters which an insurer ought to know "in the ordinary course of his business". It raises analogous issues to those raised by section 18(1) and section 19.

1.40 Section 18(3)(b) is an important protection for the policyholder. In Part 8, we analyse the case law. We conclude that the courts have reached the right results, but that the principles need to be clearer and better known.

1.41 We propose to amend the legislation to state that a policyholder need not disclose matters of common knowledge or information relating to the practices and risks of the trade which a well-informed insurer writing that particular class of business ought to know. We also propose to clarify what is meant by "known to the insurer".

The remedy

1.42 At present, the law provides only one remedy for non-disclosure or misrepresentation: avoidance of the contract. In other words, the contract is treated as if it has never been made, and all claims made under it are refused. We think that avoidance is appropriate where the policyholder has behaved dishonestly and therefore should suffer a penalty. Where the policyholder has not been dishonest, avoidance over-compensates the insurer and encourages an unduly adversarial approach.

1.43 In Part 9, we propose a new system of remedies to compensate the insurer for its loss where the policyholder has acted honestly, but has nevertheless failed to provide full and accurate information. In these circumstances, the law should aim to put the insurer into the position it would have been in had full and accurate information been provided.

1.44 These compensatory remedies look at what the insurer would have done had it known the true facts:

(1) Where the insurer would have declined the risk altogether, the policy should be avoided, the claim refused and the premiums returned.

(2) Where the insurer would have accepted the risk but included another contract term, the contract should be treated as if it included that term.

(3) Where the insurer would have charged a greater premium, the claim should be reduced proportionately. For example, if the insurer would have charged double the premium, it need only pay half the claim.

1.45 These remedies would be new for UK commercial insurance law, though they are widely used in Europe and in consumer disputes.

The duty of good faith in section 17

1.46 Section 17 of the Marine Insurance Act 1906 imposes duties of good faith on both parties. Sections 18 to 20 of the 1906 Act are specific examples of that principle in relation to non-disclosure and misrepresentation, but section 17 also extends more widely. The duty applies to both the insurer and the policyholder, both before and after the contract has been formed.

1.47 Section 17 provides only one remedy: avoidance of the contract. This is not compatible with the proportionate remedies we propose in Part 9. Nor is it compatible with the remedies for fraudulent claims we proposed in our 2011 Consultation Paper.[14]

1.48 In the course of our review, we have considered section 17 on several occasions. We summarise these discussions in Part 10. We think that the duty of good faith is important as a general interpretative principle but we do not think it should, in itself, give either a policyholder or an insurer a cause of action. Any remedies which are required, such as remedies for non-disclosure, misrepresentation or fraudulent claims, should be specified directly in the legislation.

THE STRUCTURE OF CHAPTER 1

1.49 This chapter is in nine further parts.

[14] Insurance Contract Law: Post Contract Duties and other Issues; (2011) LCCP 201/ SLCDP 152 at Part 8.

(1) Part 2 provides a brief overview of the current law of non-disclosure and misrepresentation. This Part would be helpful to those unfamiliar with insurance law, but those more conversant with the subject may wish to proceed straight to Part 3. As our proposals draw heavily on current case law a more detailed discussion of legal principles is to be found in Parts 5 to 8 together with our proposals.

(2) Part 3 looks at experience in other jurisdictions. We look at two civil law countries, Germany and France, where the onus is on insurers to ask questions. In three common law jurisdictions (Australia, New York and Ireland), the law recognises some obligation on the policyholder to volunteer information, but it is more limited than under UK law.

(3) Part 4 summarises the evidence on how the duty of disclosure works in practice and sets out the case for reform.

(4) The proposals are set out in Parts 5 to 10:

(a) Part 5 looks at the fair presentation of the risk;

(b) Part 6 considers the policyholder's knowledge;

(c) Part 7 considers the broker's knowledge under section 19;

(d) Part 8 looks at the insurer's knowledge under section 18(3)(b);

(e) Part 9 considers proportionate remedies;

(f) Part 10 considers the duty of good faith, set out in section 17.

1.50 Chapter 2 deals with warranties in insurance contracts.

1.51 Finally, in Appendix A we explain why we are not proposing to treat small businesses as consumers for the purposes of disclosure, and the reasons we are not proposing special rules to determine the status of intermediaries.

PART 2
DISCLOSURE: THE CURRENT LAW

THE MARINE INSURANCE ACT 1906

2.1 In this Part, we give a brief outline of the law of non-disclosure and misrepresentation as set out in sections 17 to 20 of the Marine Insurance Act 1906 (the 1906 Act).

2.2 Although strictly the 1906 Act is concerned only with marine insurance, these sections are considered to be the governing law for all business insurance. This is because the 1906 Act codified the common law, and judges use its provisions as an authoritative statement of common law principles. As Lord Mustill said in a leading House of Lords case:

> Although the issues arise under a policy of non-marine insurance it is convenient to state them by reference to the Marine Insurance Act 1906 since it has been accepted in argument, and is indeed laid down in several authorities, that in relevant respects the common law relating to the two types of insurance is the same, and that the Act embodies a partial codification of the common law.[1]

A CONTRACT OF THE UTMOST GOOD FAITH

2.3 Section 17 states:

> 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.

2.4 Insurance contracts are therefore one of a small number of types of contract that are of the "utmost good faith" (or, to give it its Latin tag, "*uberrimae fidei").*

2.5 The most obvious example of the duty of good faith is that the policyholder must disclose information before entering into the contract. This contrasts with the law which applies to other (non-insurance) commercial contracts, where a party must not misrepresent facts, but is under no obligation to disclose facts about which it is not asked.

2.6 The principle of good faith is wider than the policyholder's duties to provide the insurer with pre-contract information. First, the duty is said to be reciprocal, applying to both the policyholder and the insurer. We discussed the insurer's duty of good faith in Issues Paper 6, Damages for Late Payment and the Insurer's Duty of Good Faith.[2]

[1] *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* [1995] 1 AC 501 at 518, by Lord Mustill.

[2] See also Insurance Contract Law: Post Contract Duties and other Issues; (2011) LCCP 201/ SLCDP 152.

2.7 Secondly, the duty of good faith, unlike the duty to disclose, is not confined to pre-contract information but also applies throughout the life of the contract. Issues Paper 7: The Insured's Post-Contract Duty of Good Faith considered this area of law. We followed up this discussion in our second Consultation Paper, which focused specifically on the remedies for fraud.[3]

2.8 For present purposes, however, we concentrate on non-disclosure and misrepresentation. Although section 17 of the 1906 Act establishes the general principle, the specific duties are set out in sections 18 to 20. To understand the law on non-disclosure and misrepresentation, one must look at these three sections.

NON-DISCLOSURE AND MISREPRESENTATION: THE RELATIONSHIP

2.9 Misrepresentation and non-disclosure are often pleaded and considered together in court proceedings. In commercial litigation, the law of non-disclosure has tended to dominate, with relatively little attention being given to misrepresentation in an insurance context. As one textbook writer explains:

> Historically, misrepresentation in the strict sense has not been of particular importance in the insurance context. This is partly because the extreme width of the duty to disclose material facts … has meant that often non-disclosure has subsumed questions of misrepresentation. Cases have frequently failed to distinguish between the two defences taken by an insurer, and indeed it appears to be standard practice for an insurer, where possible, to plead both defences.[4]

2.10 The difference between the two has been described as follows:

> In general, non-disclosure means that you have failed to disclose something which was not the subject of a question but which was known to you and which you ought to have considered for yourself would be material, whereas a representation is something directly said in answer to a specific question, and in the present case there can be no reasonable doubt that, if in answer to the question "Has a person who is going to drive the car been convicted of an offence?" you answer "No," you are making a direct representation that such person has not been convicted. [5]

[3] Insurance Contract Law: Post Contract Duties and other Issues; (2011) LCCP 201/SLCDP 152 at Part 6.

[4] *Birds' Modern Insurance Law* (8th ed 2010), p 114.

[5] *Zurich General Accident & Liability Insurance Co v Leven* 1940 SC 406, 415, by Lord President Normand.

NON-DISCLOSURE

The duty to disclose material facts

2.11 Before entering into an insurance contract, a policyholder must volunteer all material information, even if no questions are asked. If not, the insurer may "avoid the contract" – which means that the insurer can treat the insurance contract as if it did not exist, and refuse all claims under it.

2.12 Section 18(1) of the 1906 Act expresses the obligation in the following terms:

> Subject to the provisions of this section, the assured must disclose to the insurer, before the contract is concluded, every material circumstance which is known to the assured, and the assured is deemed to know every circumstance which, in the ordinary course of business, ought to be known by him. If the assured fails to make such disclosure, the insurer may avoid the contract.

Below we look at these words in more detail.

"Before the contract is concluded"

2.13 The duty to disclose arises only before the contract. Unlike in some civil law systems, there is no general duty to inform the insurer of changes to the risk while the contract subsists.

2.14 In the UK, most insurance policies are for a fixed term, typically a year. At the end of the year, most policies fall due for renewal. The legal position is clear: a renewal is a new contract, and the duty to disclose arises again.

"Known to the assured"

2.15 Policyholders must disclose information which they know, or which they ought to know "in the ordinary course of business". This is a complex test, which we discuss in more detail in Part 6. There are two difficult questions.

2.16 First, in companies, whose knowledge counts as the knowledge of the company? In *PCW Syndicates v PCW Reinsurers*, Mr Justice Staughton commented that:

> I would have thought that knowledge held by employees whose business it was to arrange insurance for the company would be relevant, and perhaps also the knowledge of some other employees.[6]

The issue, however, is by no means clear-cut.

2.17 Secondly, what ought a policyholder to know in the ordinary course of business? There is some debate over whether this is a subjective test, based on the actual business in question, or an objective test, based on what a well-run company would know. As we discuss in Part 6, some cases apply a stricter test than others. Courts are keen to impose high standards of disclosure while recognising that, in a society in which employers' liability insurance is compulsory, even poorly-run businesses need to obtain insurance.

[6] [1996] 1 WLR 1136 at 1142.

"Every material circumstance"

2.18 Material circumstances are defined in section 18(2) of the 1906 Act:

> Every circumstance is material which would influence the judgment of a prudent insurer in fixing the premium, or determining whether he will take the risk.

2.19 The issue is therefore looked at from the point of view of a hypothetical "prudent insurer". The policyholder is required to understand what information would influence the judgment of a prudent underwriter.

2.20 Until 1994, there were two questions relating to this test:

(1) Does "would influence the judgment" require that the influence would be decisive? There are no doubt many matters of which an insurer would wish to be aware. Some will be decisive in the decision-making process - for example, a prior conviction for insurance fraud may of itself lead an insurer to decline an application. Others will not be decisive but may, taken with other factors, affect an insurer's assessment of the risk.

(2) Can an insurer avoid a policy if it was not induced to enter into it by the non-disclosure?

2.21 For English law, these questions were answered in the landmark case of *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd.*[7] The House of Lords decided that:

(1) A material circumstance is one that would have an effect on the mind of the prudent insurer in assessing the risk. It is not necessary that it would have a decisive effect on the insurer's acceptance of the risk or on the amount of premium charged.

(2) Before an insurer may avoid a contract for misrepresentation of a material circumstance it has to show that it was induced by the misrepresentation to enter into the policy on the relevant terms.

2.22 In Scots law, the *Pan Atlantic* test of materiality has been applied other than for life assurance.[8]

[7] [1995] AC 501. The case mainly concerns non-disclosure, but the tests apply equally to misrepresentation.

[8] The test in *Life Association of Scotland v Foster* (1873) 11 M 351 (materiality to the reasonable person in the position of the insured) has been held to apply to life and health insurance cases in Scotland; see *Hooper v Royal London General Insurance Co Ltd* 1993 SLT 679 and *Cuthbertson v Friends' Provident Life Office* 2006 SLT 567. In all other types of insurance, however, the relevant test is that in *Pan Atlantic*; see for example *Gaelic Assignments Ltd v Sharp* 2001 SLT 914 and *Mitchell v Hiscox Underwriting Ltd* [2010] CSIH 18; 2010 GWD 13-244.

2.23 Following the case, the inducement test has been clarified and developed and is now a clearly established part of the law in the UK. It has often been used to mitigate the harsh effects of the duty of disclosure. We look at this in more detail in Part 5. Although in *Pan Atlantic*, the court thought that there was a "presumption of inducement", it is now clear that the insurer must prove that it would have acted differently had it known the full facts.

Exceptions to the duty to disclose

2.24 Section 18(3) of the 1906 Act sets out four exceptions to the general duty of disclosure. An insured need not disclose:

> (a) any circumstance which diminishes the risk;
>
> (b) any circumstance which is known or presumed to be known to the insurer. The insurer is presumed to know matters of common notoriety or knowledge, and matters which an insurer in the ordinary course of his business, as such, ought to know;
>
> (c) any circumstance as to which information is waived by the insurer;
>
> (d) any circumstance which it is superfluous to disclose by reason of any express or implied warranty.

Of this list, the two most important exceptions are (b) and (c), outlined below.

Circumstances which the insurer knows or is presumed to know

2.25 We discuss section 18(3)(b) in Part 8. The exception not only covers circumstances which the insurer knows but also circumstances which an insurer is presumed to know. This covers matters of common knowledge and more specialist industry knowledge which an insurer ought to know "in the ordinary course of his business".

Waiver

2.26 In Part 5 we discuss section 18(3)(c) of the 1906 Act where information is "waived by the insurer". Several court judgments have used this provision as a way of protecting policyholders from the full harshness of section 18(1).[9] They have done this by giving "waiver" a much broader meaning than it has in other areas of law. In most contexts, waiver requires an intentional act with full knowledge of the facts. In this context, an insurer may waive by omission.

Fair presentation of the risk

2.27 The waiver exception has been used to encourage insurers to take a more active role in assessing the risk. The courts have held that if a policyholder makes a fair presentation of the risk, which would prompt a reasonably careful insurer to make further enquiries, the insurer who fails to make such enquiries has waived the information which further inquiries would have revealed.

[9] These are discussed at Part 5.

2.28 The following key passage in a leading textbook, *MacGillivray,* was affirmed in *WISE (Underwriting Agency) Ltd v Grupo Nacional Provincial SA* (Court of Appeal):[10]

> [T]he assured must perform his duty of disclosure properly by making a fair presentation of the risk proposed for insurance. If the insurers thereby receive information from the assured or his agent which, taken on its own or in conjunction with other acts known to them or which they are presumed to know, would naturally prompt a reasonably careful insurer to make further inquiries, then, if they omit to make the appropriate check or inquiry, assuming it can be made reasonably, they will be held to have waived disclosure of the material fact which that inquiry would have necessarily revealed. [11]

2.29 This test is an objective one, the relevant standard being that of a reasonably careful insurer. Lord Justice Rix described this hypothetical insurer as being "neither a detective on one hand nor lacking in common sense on the other", noting that "mere possibilities will not put him on inquiry".[12]

2.30 In Part 5, we discuss the way in which the courts have developed a test based on the fair presentation of the risk. We think this is a useful development, which needs to be better known. We propose that the legislation should be amended to include principles drawn from the case law.

LIMITED QUESTIONS

2.31 An insurer who asks an expressly limited question may be taken to indicate that it has no interest in information which falls outside the scope of that question. If so, it will be deemed to have waived such information. In *Doheny v New India Assurance Ltd* (Court of Appeal) Lord Justice Longmore outlined the test to be applied:

> Whether or not such a waiver is present depends on a true construction of the proposal form, the test being, would a reasonable man reading the proposal form be justified in thinking that the insurer had restricted his right to receive all material information, and consented to the omission of the particular information in issue?[13]

2.32 An example would be a form which asks about claims in the last five years. An insurer who asks such a question would normally be taken to have waived information about claims made more than five years ago.

[10] [2004] EWCA Civ 962; [2004] 2 All ER 613, [63].

[11] Legh-Jones, Birds and Owen, *MacGillivray on Insurance* (11th ed 2008), at 17-083. The Scots law position on waiver is similar; see Reid & Blackie, *Personal Bar* (2006), pp 238 - 242.

[12] [2004] EWCA Civ 962; [2004] 2 All ER 613, [64].

[13] [2004] EWCA Civ 1705; [2005] Lloyd's Rep IR 251, [19].

DISCLOSURE BY THE BROKER

2.33 Where insurance is placed through a broker or other agent, section 19 of the 1906 Act permits an insurer to avoid the contract if the policyholder's agent has failed to disclose information. It reads as follows:

> Subject to the provisions of the preceding section as to circumstances which need not be disclosed, where an insurance is effected for the assured by an agent, the agent must disclose to the insurer-
>
> (a) Every material circumstance which is known to himself, and an agent to insure is deemed to know every circumstance which in the ordinary course of business ought to be known by, or to have been communicated to, him; and
>
> (b) Every material circumstance which the assured is bound to disclose, unless it come to his knowledge too late to communicate it to the agent.

2.34 Although section 19 of the 1906 Act appears to place a duty on the agent, this may be a misleading way of characterising the provision. The section does not impose any penalty on the agent. In *HIH Casualty and General Insurance Ltd v Chase Manhattan Bank*, the court found that breach of section 19 did not give the insurer the right to claim damages against the agent.[14]

2.35 Instead, it is well established that a breach of section 19 gives the insurer the right to avoid the contract against the policyholder.[15] It is therefore the policyholder who has the interest in making sure that the insurer receives full disclosure and who stands to lose should the section be breached.

Section 19(b)

2.36 This requires the agent to disclose every fact that the applicant for insurance is bound to disclose. At first sight, this seems reasonable. However, where a policyholder has failed to disclose something it should have disclosed, the insurer already has a right to avoid on that basis. Section 19(b) appears to add little to an insurer's existing remedies for non-disclosure under section 18.

Section 19(a)

2.37 Section 19(a) of the 1906 Act is more problematic, because it appears to extend the limits of disclosure beyond section 18. Under section 18(1), the policyholder need only disclose information which it knew or ought to have known. Under section 19(a), the policy may also be avoided if there was a failure to disclose circumstances which the broker knew or ought to have known, even if there was no reason for the policyholder to be aware of them.

[14] [2003] 2 Lloyd's Rep 61, [2003] UKHL 6. The agent would be liable too but only where the agent's conduct amounted to a negligent or fraudulent misrepresentation, assuming that the necessary common law requirements for such an action could be established. See also Part 7 at para 7.13 and following.

[15] *Colinvaux & Merkin's Insurance Contract Law,* p 10764, para A-0790.

2.38 In Part 7, we discuss the problems with this section and suggest possible reforms.

MISREPRESENTATION

Representations must be true

2.39 In addition to the duty to disclose, the policyholder is under a duty not to misrepresent material facts. Section 20(1) of the 1906 Act states:

> Every material representation made by the assured or his agent to the insurer during the negotiations for the contract, and before the contract is concluded, must be true. If it be untrue the insurer may avoid the contract.

2.40 In many ways, the law of misrepresentation follows that of disclosure. In particular, the test of materiality is the same. The definition of a material representation in section 20(2) repeats the test in section 18(2): it must influence the judgment of a prudent insurer in fixing the premium or deciding whether to take the risk. The inducement test established in *Pan Atlantic* also applies with equal force to misrepresentation.

Fact or belief?

2.41 The main difference between the law of disclosure and the law of misrepresentation is that a misrepresentation does not depend on what the policyholder knew or ought to have known. A policyholder may make a statement believing it to be true, and with no reason to think it is untrue. If the statement is one of fact, the law imposes strict liability. It is no defence that the misrepresentation was made innocently. On the other hand, if the statement is one of "expectation or belief", it only needs to be made in good faith.

2.42 Thus section 20(3) of the 1906 Act states:

> A representation may be either a representation as to a matter of fact, or as to a matter of expectation or belief.

2.43 Section 20(4) applies to factual representations:

> A representation as to a matter of fact is true, if it be substantially correct, that is to say, if the difference between what is represented and what is actually correct would not be considered material by a prudent insurer.

2.44 By contrast, section 20(5) applies to representations of expectation or belief:

> A representation as to a matter of expectation or belief is true if it be made in good faith.

2.45 Section 20(5) appears to say that it is sufficient if a belief is honest: it does not also have to be reasonable. This differs from general contract law, where the courts have held that an opinion or belief must not only be honestly held but also, in some circumstances, based on reasonable grounds.[16] We discuss this in more detail in Part 5.

REMEDIES

Avoidance

2.46 The remedy for non-disclosure or misrepresentation is that the insurer may avoid the contract. The contract is treated as if it never existed, and the insurer may refuse all claims made under it.

Return of premiums

2.47 Avoidance normally requires restitution: the parties must be restored to the positions they were in prior to the contract being made. Thus the policyholder may demand the return of the premium paid, but there is an exception in the case of fraudulent misrepresentation. For marine insurance, section 84(3)(a) of the 1906 Act states:

> Where the policy is void, or is avoided by the insurer as from the commencement of the risk, the premium is returnable, provided that there has been no fraud or illegality on the part of the assured...

2.48 For non-marine insurance, the point is not wholly clear, and depends on general principles of contract law or the law of unjustified enrichment.[17]

The Misrepresentation Act 1967

2.49 In England and Wales section 2(2) of the Misrepresentation Act 1967 gives the court discretion to declare a contract as subsisting and to award damages in lieu of rescission for non-fraudulent misrepresentation.[18] In principle this section might be applied to an insurance case, but it has been held that it should not normally be applied to commercial insurance, because avoidance of the contract acts as a deterrent against misrepresentations being made.[19]

[16] *Brown v Raphael* [1958] Ch 636. There is no Scottish case directly in point; see generally McBryde, *The Law of Contract in Scotland* (3rd ed 2007), paras 6-22 – 6-23.

[17] See *Berg v Sadler & Moore* [1937] 2 KB 158; *Clough v London and North Western Railway Co* (1871-72) LR 7 Ex 26; and *Standard Life Assurance Co v Weems* (1884) 11 R (HL) 48.

[18] The measure of damages is obscure. See Issues Paper 1: Misrepresentation and Non-Disclosure (2006), paras A23 to A24. There is no equivalent provision in Scots law.

[19] *Highland Insurance Co v Continental Insurance Co* [1987] 1 Lloyd's Rep 109, 118 by Steyn J (as he then was) commented "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 from avoidance on the grounds of material misrepresentation the efficacy of those rules will be eroded."

Damages

No damages for non-disclosure

2.50 Despite some contrary suggestions,[20] it seems to be accepted as settled law in England and Wales that even deliberate non-disclosure does not give rise to liability in damages, as deceit or fraud requires a positive misrepresentation.[21]

2.51 In Scots law, however, although silence does not usually constitute a misrepresentation, where the law recognises a duty to disclose, a failure to do so will amount to a misrepresentation.[22]

Possible damages for misrepresentation

2.52 In general contract law, the victim of a misrepresentation who has suffered loss may claim damages from the maker of the misrepresentation who has acted fraudulently or negligently.

2.53 In England and Wales, the victim of a fraudulent misrepresentation is entitled to claim damages for deceit. For negligent misrepresentations, the Misrepresentation Act 1967 provides that a party who makes a non-fraudulent misrepresentation will be liable in damages "as if he were fraudulent" unless he proves that he had reasonable grounds to believe, and did believe up to the time the contract was made, that the facts represented were true.[23]

2.54 In Scotland there is also a common law liability for fraud. Fraudsters must make reparation for loss caused by any material statement they know is not true, or if they know the statement may or may not be true and make it nonetheless and the other party suffers a loss through relying on the untrue statement.[24] Originally, damages could not be claimed for negligent misrepresentation, but this barrier was removed by section 10(1) of the Law Reform (Miscellaneous Provisions) (Scotland) Act 1985.

[20] *HIH Casualty & General Insurance Ltd v Chase Manhattan Bank* [2001] EWCA Civ 1250; [2001] 2 Lloyd's Rep. 483 at [48], [164] and [168]; see also *Conlon v Simms* [2006] EWHC 401 (Ch); [2006] 2 All ER 1024 (partnership).

[21] *HIH Casualty & General Insurance Ltd v Chase Manhattan Bank* [2003] UKHL 6; [2003] 1 All E.R. (Comm) 349 at [75] ("nondisclosure (whether dishonest or otherwise) does not as such give rise to a claim in damages"). See also *Manifest Shipping Co v Uni-Polaris Insurance Co, The Star Sea* [2001] UKHL 1; [2003] 1 AC 469 at [46]; and B*anque Financiere de la Cite SA v Westgate Insurance Co* [1990] 1 QB 665 at 781.

[22] MacQueen and Thomson, *Contract Law in Scotland* (2007), p 88. See also *Gillespie v Russel* (1856) 18 D 677, 686 by Lord Curriehill. Also, see Part 2, paras 2.52 to 2.55 on possible damages for misrepresentation.

[23] Misrepresentation Act 1967, s 2(1).

[24] *Derry v Peek* (1889) LR 14 App Cas 337.

2.55 In theory, an insurer may be able to use these causes of action to claim damages against a policyholder. In practice, however, the right to damages appears to be unimportant. A leading authority on English insurance writes that there are no known cases in which an insurer has claimed damages from a policyholder.[25] This is perhaps not surprising, even in cases of fraud. The main potential loss to the insurer will normally be prevented by avoidance of the policy, and if there has been fraud the insurer's right to retain the premium may cancel out any further loss.

[25] M A Clarke, *The Law of Insurance Contracts* Vol 2, Chap 23, para 23-15.

PART 3
DISCLOSURE: COMPARATIVE LAW

3.1 Although a duty of disclosure was enshrined in many other common and civil law countries, some have introduced reform to curb the extent of the duty. In this Part we provide a brief outline of the law in Australia, New York, Ireland, Germany and France.[1] We conclude by looking at the approach to disclosure taken by the Principles of European Insurance Contract Law (PEICL).[2] We have selected these particular examples as representative samples of the various approaches adopted in other jurisdictions.

AUSTRALIA

3.2 Before 1984, Australian insurance law closely resembled its English counterpart. The Insurance Contract Law Act 1984 (the 1984 Act) introduced major reforms to general insurance law, though it excluded marine insurance.[3] The Act followed the Australian Law Reform Commission's 1982 Report on the subject.[4]

3.3 The 1984 Act retains the duty of disclosure, but replaces a materiality test based on a prudent underwriter with a test based on a reasonable insured. Section 21 requires the insured to disclose any matter which:

(1) the insured knows to be a matter relevant to the decision of the insurer whether to accept the risk and, if so, on what terms, or

(2) a reasonable person in the circumstances could be expected to know to be a matter so relevant to the insurer.

3.4 Section 22 of the 1984 Act provides that an insurer may only rely on the duty if it has informed the insured about it.

3.5 If the non-disclosure is fraudulent, the insurer may avoid the contract (though this is subject to the court's discretion to prevent this if avoidance would be too harsh). Otherwise, an insurer is granted a remedy only to the extent that the non-disclosure made a difference to the terms on which it contracted. For example, if it would have charged a higher premium had it known the undisclosed fact, then the claim will be reduced by the amount of extra premium that would have been charged.[5]

1 See also Issues Paper 1: Misrepresentation and Non-disclosure (September 2006) at Appendix G, which summarises the law in Australia, New York, France and Norway.

2 Section 19 of the 1906 Act places a duty of disclosure on a broker which we deal with at Part 7. This is also part of the law in the Republic of Ireland and in Australia where the duty has been retained for marine insurance. However, the other jurisdictions we look at in the Part do not have an exact equivalent to the section as most regulate the broker's duty through the law of agency, which is beyond the scope of this Paper.

3 R Merkin, *Reforming insurance law, is there a case for reverse transportation?* Report for the English and Scottish Law Commission on the Australian experience of insurance law reform (2007).

4 ALRC 20.

5 Insurance Contract Law Act 1984, s 28.

3.6 Initially, the duty of disclosure also applied to consumer insurance, but a new section 21A, was added in 1999. This provides that for most forms of domestic policy the duty of disclosure is waived unless the insurer has asked specific questions.

3.7 A paper prepared for us in 2006 by Professor Merkin found that the test was working well in the Australian market at that time.[6] One criticism made of the reasonable insured test, however, is that it is uncertain. Since 2006 two Bills have been proposed to amend section 22 of the 1984 Act and to clarify how the test should be applied, though neither has been enacted.

3.8 The first, the Insurance Contracts Amendment Bill 2007, would have inserted a non-exhaustive list of factors to which regard could be had to determine what a reasonable insured could be expected to know. The second was the Insurance Contracts Amendment Bill 2010, which would have required a consideration of the nature and extent of the cover provided under the policy when deciding the same issue. The 2010 Bill lapsed when the House of Representatives dissolved for Federal elections and it awaits reintroduction.

NEW YORK

3.9 New York has retained the duty to disclose only for certain types of insurance – marine and reinsurance. For other types of insurance, the insurer only has a remedy if there has been a misrepresentation or a "wilful concealment".

3.10 New York law requires that all policies of life insurance contain certain provisions,[7] commonly referred to as the "165 lines". The first six lines (headed "concealment, fraud") provide:

> This entire policy shall be void if, whether before or after a loss, the insured has wilfully concealed or misrepresented any material fact or circumstance concerning this insurance or the subject thereof, or the interest of the insured therein, or in any case of fraud or false swearing by the insured relating thereto.

Similar provisions are also mandated for other types of insurance.

3.11 The main protection for the insurer lies in avoidance of a policy for misrepresentation. This applies whether or not the misrepresentation is intentional.[8]

[6] R Merkin, *Reforming insurance law: is there a case for reverse transportation?* Report for the English and Scottish Law Commissions on the Australian experience of insurance law reform (2007).

[7] New York Insurance Law, s 3404.

[8] New York Insurance Law, s 3105. For example, see *Parmar v Hermitage Insurance Co*, 21 AD 3d 538, 800 NYS 2d 726 (NY App Div 2005).

3.12 Even in the absence of a misrepresentation, the policy may also be avoided for "wilful concealment". This has been applied to partial answers: where, for example, the insured was asked whether he had received medical advice, and listed some ailments but not others.[9] The courts, however, have often been reluctant to allow the insurer to avoid a policy where the insurer failed to ask questions, and the insured did not volunteer information. For example, where an insurer did not ask whether a product had previously been contaminated, the court held that there was no duty to mention it.[10]

3.13 That said, the concept of "wilful concealment" is flexible. In a paper for us on the duty to disclose in New York law, David W Kenna comments:[11]

> … although courts have repeatedly held that an insured is under no obligation to volunteer information about which it is not questioned, the following has been noted as well:
>
> > If the applicant is aware of the existence of some circumstances which he knows would influence the insurer in acting upon his application, good faith requires him to disclose that circumstance, though unasked.[12]

3.14 The crucial issue is whether the concealment was fraudulent. If the issue was so obviously material to the risk that the applicant acted deliberately in concealing it, then the insurer does not necessarily have to show that a question was asked.

THE REPUBLIC OF IRELAND

3.15 Before 1922, insurance law in Ireland was governed by the Marine Insurance Act 1906 and followed English case law. Today, the 1906 Act continues to be part of Irish law, but Irish judges have given it a more restricted interpretation than in the UK. In its 2011 Consultation Paper, the Law Reform Commission commented that exceptions "have been used very liberally by Irish judges":

> An insurer who fails to inspect a property for example, or who fails to ask questions relating to the risk will be in danger of being held to have waived the need to disclose.[13]

3.16 An example is *Manor Park Homebuilders Ltd v AIG Europe (Ireland) Ltd*,[14] where the proposer for fire insurance failed to mention the security measures. Mr Justice McMahon commented that the duty of disclosure does not mean that:

9 *Vander Veer v Continental Cas Co*. 34 NY 2d 50.

10 *National Union Fire Ins Co of Pittsburgh PA v Stroh Cos, Inc*, 265 F.3d 97 (2d Cir 2001).

11 "New York Insurance law on Duty to Disclose Information on an Insurance Application" (June 2010 and updated April 2012). We are very grateful to David W Kenna and to Mound Cotton Wollan & Greengrass for the Paper. A copy of the advice is available at www.lawcom.gov.uk and www.scotlawcom.gov.uk.

12 *Sebring v Fidelity-Phoenix Fire Ins Co of New York*, 255 NY 382, at 387 (1931).

13 LRC CP 65-2011, para 3.42.

14 [2009] 1 ILRM 190.

> … the insurer can cover its eyes or abstain from making normal inquiries or investigations, in the expectation that, in the event of the risk materialising, it can point to the insured's omission and repudiate the contract. The insured's duty is balanced by a reciprocal duty on the insurer to make its own reasonable inquiries, to carry out all prudent investigations and to act at all times in a professional manner. In fact the onus to do this, because of its experience and expertise, lies primarily on the insurer.[15]

3.17 The Law Reform Commission argues that despite these cases, there is still a need for legislative reform.

> The Commission consider that, insofar as the outcome of a case may turn on whether a proposal form was or was not used…, the Irish courts have provided an invaluable starting point, but that a thorough and systematic overhaul of Irish insurance contract law can best be achieved through legislation.[16]

3.18 As far as the duty to disclose is concerned, the Commission make four main proposals:

(1) That the insurer shall not be permitted to repudiate liability on the basis of non-disclosure of material facts of which the insured could not reasonably be expected to have actual knowledge at the time of applying for cover.[17]

(2) The definition of "material facts" should be seen from the perspective of a reasonable insured. The Commission suggest two possible formulations:

  (a) Facts which, in the circumstances, a reasonable insured would know to be highly relevant and should be disclosed; or

  (b) Facts which, in the circumstances, a reasonable insured would know to have a decisive influence on the insurer's decision in accepting the risk or in setting the level of premium.[18]

(3) The insurer should be under a statutory duty to explain to a proposer both the nature of the duty of disclosure and the consequences of a non-disclosure.[19]

[15] See also *Aro Road and Land Vehicles Ltd v Insurance Corporation of Ireland* [1986] IR 403, where the proposer bought property insurance over the telephone. No questions were asked and the proposer failed to mention a criminal conviction 19 years earlier. The court held that insurance is a contract of good faith on both sides. The insurer had forfeited the right to insist on full disclosure by failing to ask questions.

[16] LRC CP 65-2011, para 3.26.

[17] LRC CP 65-2011, para 3.28.

[18] Above, para 3.37.

[19] Above, para 3.103.

(4) Avoidance of the policy should no longer be the main remedy, and that in cases of non-disclosure and misrepresentation the principal remedy should be one of damages in proportion to the failure by the insured.[20]

GERMANY

3.19 The German Insurance Contract Law (the Versicherungsvertragsgesetz or VVG) first introduced in 1908 was comprehensively reformed in 2007.[21] The reforms address both consumer and business insurance, although exclude marine insurance and some large risks as defined by the German Insurance Supervision Code (Versicherungsaufsichtsgesetz or VAG).[22]

3.20 Prior to the formation of the contract, the insurer is under a duty to inform policyholders of their rights and obligations and a further duty to continue to provide information to the insured during the currency of the contract.[23] Special rules apply to distance selling.

3.21 The VVG, section 19 modifies the insured's duty to disclose in that it only applies to facts asked for by the insurer. Where the insured is in breach of this duty a range of consequences follow, depending on the nature of the breach and how the insurer would have acted had the duty been complied with.

3.22 Where the insured has acted fraudulently the insurer may avoid the contract.[24] Where the insured has breached the duty of disclosure the insurer is entitled to withdraw from the contract, but this is subject to the proviso that where the breach has been neither intentional nor grossly negligent the insurer cannot withdraw, but instead may terminate the contract on one month's notice.[25]

3.23 If the insured has been grossly negligent the insurer may terminate the contract immediately, unless the insurer would nevertheless have entered into the contract had they known the facts, but on different terms. In that case the different terms become part of the contract with retrospective effect where the insurer requests this.[26] Where this would have led to an increase in the premium charged in excess of 10%, or if the insurer refuses to cover the entire risk the insured may terminate the contract.[27]

3.24 The insurer must assert its rights under section 19 of the VVG in writing, and within a month of learning of the breach by the insured of the duty of disclosure.[28]

[20] Above, para 10.21.

[21] The reforms came into effect on 1 January 2008 subject to certain transitional provisions.

[22] These include all forms of goods in transport, railway rolling stock, aviation and third party liability arising out of aviation, liability for ships and liability for land transport.

[23] VVG, ss 6 and 7.

[24] VVG, s 22.

[25] VVG, s19 (2) and (3).

[26] VVG, s 19 (4).

[27] VVG, s 19 (6).

[28] VVG, s 21.

3.25 In 2009, the International Bar Association Legal Practice Division drafted a Report on the reforms. It concluded that they were generally welcomed by the market "as providing increased transparency and a fundamental modernisation" of the contractual relationship. On the other hand there was widespread agreement that it had imposed additional administrative burdens which "will continue to cause premiums to increase".[29]

FRANCE

3.26 The Civil Code (CC) sets out general rules of contract law. There is also specific legislation on insurance contract law. The Code des assurances (CA), art L.113-2 provides that the insured shall truthfully answer questions put to them by the insurer at the time the contract is executed about circumstances that enable the insurer to assess the risks it covers.

3.27 Where the insured makes an intentional or fraudulent misrepresentation, the contract is null and void. This is true if the misrepresentation changes the subject of the risk or decreases the insurer's assessment of the risk, even if it has no impact on the loss.[30]

3.28 In the absence of bad faith the insurer is not entitled to avoid the contract. If the misrepresentation is discovered prior to any loss being incurred, the insurer is entitled to continue the contract, subject to an increase in the premium payable, or to terminate the contract on 10 days notice. If it is discovered after a loss, the insurer may reduce the amount payable under the claim in the proportion of the difference between the amount paid as premium against what would have been charged as premium had the facts been known.[31]

PRINCIPLES OF EUROPEAN INSURANCE CONTRACT LAW

3.29 In 1998, a project group was formed to restate common principles of European insurance contract law. The result was published in 2009: the Principles of European Insurance Contract Law (PEICL). This draws on the civil law tradition, by setting out a much more limited duty to disclose. The basic principle is set out in Article 2:101(1):

> When concluding the contract, the applicant shall inform the insurer of circumstances of which he is or ought to be aware, and which are the subject of clear and precise questions put to him by the insurer.

3.30 In addition, if the policyholder supplies additional information to the insurer at the time of concluding the contract, this information must be as accurate and complete as the information supplied in response to the insurer's questions. [32]

[29] The new German Insurance Contract Law: a year one progress report and comparison with the UK position; Eichhorst and Heuvels, Vol 16 No 1, May 2009.

[30] CA, art L 113 – 8.

[31] CA, art L. 113 – 9.

[32] PEICL, art 2.105.

3.31 In the absence of clear, precise questions, there is no duty to disclose. Article 3:103 sets out further exceptions. The duty does not apply in respect of information:

(1) which was obviously incomplete or incorrect;

(2) which was not material to a reasonable insurer's decision to enter the contract at all, or to do so on the agreed terms;

(3) which the insurer led the policyholder to believe did not have to be disclosed; or

(4) of which the insurer was or should have been aware.

3.32 Where the insured is in breach of the duty of disclosure, Article 2:102 allows the insurer to terminate the contract or to propose a reasonable variation of the contract. The insurer's right to vary the contract in response to the insured's breach is limited by the requirement that the variation must be reasonable, and be accepted by the insured before the variation can take effect.

3.33 Under Article 2:104, the insurer may avoid the policy for a fraudulent breach. In other cases, the insurer may terminate the insurance policy for the future if the inaccurate or undisclosed information was so material to the risk that it would not have concluded the contract at all had it been fully informed; alternatively, it may be terminated where the insured rejects the insurer's proposed variation to the contract.[33] Where a claim has already arisen, the remedy is set out in Article 2:102(5):

> If an insured event is caused by an element of the risk, which is the subject of negligent non-disclosure or misrepresentation by the policyholder, and occurs before termination or variation takes effect, no insurance money shall be payable if the insurer would not have concluded the contract had it known the information concerned. If, however, the insurer would have concluded the contract at a higher premium or on different terms, the insurance money shall be payable proportionately or in accordance with such terms.

3.34 An important limitation is that the claim and the non-disclosure must relate to the same element of the risk: thus if the proposer fails to mention a broken fire alarm, this would have no effect on a flooding claim. In a burglary claim, the insurer would have proportionate remedies: if the insurer would not have written the risk at all, it may refuse the claim; if it would have charged more, it must pay a proportion of the claim.

CONCLUSION

3.35 By international standards, UK insurance law appears to be particularly favourable to the insurer.

[33] Art 2:102, para 2.

3.36 In the civil law countries we have considered, the onus is on the insurer to ask questions. Furthermore, avoidance is restricted to intentional or fraudulent misrepresentations: in the absence of bad faith, proportionate remedies are applied.

3.37 In Australia, New York and Ireland, there is still a requirement on the insured to volunteer information, but the requirement is more limited than in the UK. The three jurisdictions have taken different approaches to limiting the duty. In Australia, the issue is whether "a reasonable person in the circumstances" could be expected to know that the matter was relevant to the insurer. In New York, the test is whether the insured "wilfully concealed" the matter. In Ireland the courts have stressed that:

> The insured's duty is balanced by a reciprocal duty on the insurer to make its own reasonable inquiries, to carry out all prudent investigations and to act at all times in a professional manner.[34]

3.38 As we discuss in Part 5, the UK courts have also recognised some requirement on the insurer to ask questions, but it appears less extensive than in Ireland.

[34] See also fn 15 above for commentary on *Aro Road and Land Vehicles Ltd v Insurance Corporation of Ireland* [1986] IR 403.

PART 4
DISCLOSURE: THE CASE FOR REFORM

INTRODUCTION

4.1 The policyholder tends to know more about the risk than the insurer and this makes it particularly important that the law encourages the full and frank exchange of information. In this Part, we start by outlining the reasons for the duty of disclosure. Effective disclosure supports a strong UK insurance market so that it can competitively and efficiently cover a huge variety of general and specialist risks, many of which are international.

4.2 There is a growing body of evidence, however, that the duty of disclosure does not work well in practice. We summarise evidence from consultees, from Airmic's survey,[1] and from the Mactavish Report[2] that many of those who buy insurance on behalf of companies do not understand the full extent of the duty imposed on them by section 18 of the Marine Insurance Act 1906 (the 1906 Act). Even if the duty is understood, in some larger companies it may be almost impossible to comply with.

4.3 Section 18 may also encourage insurers to play an unduly passive role. There is a danger of "underwriting at claims stage" whereby the insurer agrees to the risk, however inadequately presented, and asks questions only if a claim arises. The remedy of avoidance then puts the insurer into a strong position as against the policyholder. If the insurer discovers that the policyholder has failed to disclose a material circumstance, it may refuse all claims, even for a relatively minor non-disclosure which would only have led the insurer to add a small amount to the premium.

4.4 Of course in many cases insurers pay a claim through goodwill, but there are indications that as the insurance market hardens, goodwill will wear thin. Section 18 of the 1906 Act generates a high volume of disputes and litigation. It also leads to a high number of reported cases. We identified 41 reported judgments on section 18 from January 2002 to January 2012.[3] This issue is one where legal clarity is crucial.

4.5 In 2007, we proposed to replace a test of materiality based on "the prudent insurer" with a test based on what a "reasonable insured" would consider to be relevant. Many respondents thought that this test would be too uncertain. On balance we agree. In the following Parts we now propose a more evolutionary approach, based on principles drawn from the current cases.

[1] AIRMIC Non-disclosure of material information - Member Survey (2010).

[2] Mactavish Corporate Risk & Insurance - The Case for Placement Reform. The Mactavish Protocols (2011). Mactavish is a research and advisory business specialising in the analysis of commercial risk, insurance policy reliability and insurance governance. See further Part 1, fn 1.

[3] The figure includes 26 English High Court cases, 12 Court of Appeal cases and 3 Scottish Court of Session cases.

THE REASONS FOR A DUTY TO DISCLOSE

4.6 The first question is whether a policyholder should be under any duty to volunteer information to an insurer. As we have seen, in some jurisdictions, the policyholder's only duty is to answer the insurer's questions. In 2007, we proposed that for consumer insurance the duty to volunteer information should be replaced by a duty not to misrepresent, and this has now been enacted by the Consumer Insurance (Disclosure and Representations) Act 2012.[4]

4.7 For business insurance we proposed that the duty of disclosure should be retained for four reasons:

(1) The duty of disclosure has become part of the way the UK business insurance market works. For many business policies, there is no proposal form. Instead the broker presents the risk, and the underwriter relies on that presentation.

(2) Business insurance involves a much greater variety of unusual or specialist risks than consumer insurance. That would make it harder for the insurer to ask questions about all relevant matters.

(3) A greater proportion of business insurance is conducted through full-time professional intermediaries, who can advise as to what is required.

(4) Requiring insurers to ask questions even when both parties are sophisticated in insurance matters could lead to an empty formalism. If underwriters ask a general question such as "is there anything else that we should know about?" the duty would effectively be restored.[5]

4.8 Our proposal to retain the duty of disclosure received overwhelming support. Many respondents pointed out that the UK insurance market was the largest and most international in Europe. It insures a huge variety of specialist risks, where the essence of the risk cannot be captured in standard questions.

4.9 Beachcroft LLP, for example, argued that the duty should be retained as it "acknowledges the enormous variety of insureds". Insurers cannot be expected to know enough of the technical details of sophisticated businesses' operations to ask all the necessary questions. The City of London Law Society agreed that the duty to disclose supported a strong London market whereby major insurance transactions could be underwritten without:

> … an enormous amount of due diligence being carried out with underwriters relying on insureds and their professional advisors to provide material information.

If the duty was abolished it could lead to insurers producing "very long lists of questions and requests for information". This would slow operations and add to costs.

[4] Section 2(2).

[5] Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured; (2007) LCCP 182/SLCDP 134 at paras 5.24 to 5.30.

4.10 Insurance provides firms with access to contingent capital – that is access to funds in circumstances when they most need it. Compared with the costs of accessing other capital, such as bank loans, insurance is a cheap option, with lower administrative costs or arrangement fees. Insurance is a cost-effective way to access capital and we would not wish to hinder that.

4.11 The response of Kendall Freeman collated the views of senior representatives from organisations with a direct interest in the insurance industry.[6] They reported that:

> It was recognised that there was a move across Europe towards restricting the duty of disclosure. The majority view was that the duty of disclosure for business insureds should, however, remain. The alternative, for insurers to ask specific questions, was impractical, particularly for more specialised risks and where there is a higher turnover of business as compared with other parts of Europe.

4.12 We agree that the duty of disclosure is part of how the UK insurance market works for large and specialist risks. The market has many strengths, and is able to cover a huge variety of risks competitively and efficiently. The duty of disclosure underpins this strength.

4.13 On the other hand, there are some difficulties in the way that disclosure operates in practice. Policyholders need more clarity about what must be disclosed, while more needs to be done to encourage insurers to play an active role in assessing risks. Below we summarise the evidence about the practical problems in relation to disclosure and consider what can be done to clarify the scope of the duty.

SMALL AND LARGER BUSINESSES

4.14 In 2007, we assumed that small businesses would experience the greatest problems in complying with section 18 of the 1906 Act. In 2009, we tentatively proposed special protection for micro-businesses with fewer than 10 employees.[7] Further consultation, however, showed that the main problems with section 18 appear to be experienced by larger businesses.

Problems for small businesses

4.15 The Appendix summarises the result of our consultation about the problems in the small business market. We consulted small business organisations, insurers, brokers and the Financial Ombudsman Service (FOS) about the problems facing small businesses. The British Insurance Brokers' Association (BIBA) also conducted a survey of their members.

[6] Kendall Freeman Solicitors held a series of meetings with representatives from organisations with a direct interest in the project, including those that represented brokers, insurers, reinsurers, insureds, the FSA, capital managers and other consultants.

[7] See Issues Paper 5: Micro- Businesses (April 2009), at paras 10.7 to 10.22.

4.16 During consultation it became clear that there was no simple definition of a micro-business. Any definition would be complex and difficult to apply. Furthermore, we found little evidence that, in practice, the current law causes particular problems for small businesses. As we discuss in the Appendix, over half of brokers responding to the BIBA survey said that none of the claims they had dealt with in the last two years involved a dispute about non-disclosure or misrepresentation. Of those who had been involved in such a dispute, most had encountered five or fewer disputes, and these disputes tended to involve relatively small amounts of money.[8] We concluded that the evidence of problems was insufficient to justify a third legal regime, which would impose additional administrative costs on insurers.

4.17 In this market, insurers rarely rely on the policyholder's duty to volunteer information. Instead, they ask firms specific questions. The courts have increasingly held that if an insurer asks a question, it is taken to have waived its right to further disclosure on the same issue. Thus the burden of disclosure is less onerous. The small business is expected to mention unusual or special risks, but it is not expected to second-guess everything the insurer might want to know. Furthermore micro-businesses are entitled to complain to the FOS, which is not bound by the letter of the law. The FOS can apply consumer-type protection if it thinks it fair and reasonable to do so.

Problems for larger businesses

4.18 As the project progressed, it became increasingly clear that section 18 of the 1906 Act causes serious problems for larger businesses, which are expected to present risks without the benefit of questions.

4.19 Below we summarise the evidence concerning problems in the large business market. Many business managers do not know the law; and even if they are familiar with the words of section 18, they have little idea of how to meet the duty in practice. Large companies are much more complex than they were in 1906, with knowledge spread through hundreds, if not thousands, of employees, often throughout the world. It is unclear which knowledge is relevant to the insurer, or how it should be collected. Policyholders often depend on an insurer's forbearance to pay claims with all the uncertainty that entails.

LARGER BUSINESSES: EVIDENCE OF PROBLEMS

Responses to our 2007 Consultation Paper

4.20 The first problem is that buyers do not understand the duty of disclosure. As the Construction Industry Council commented:

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

4.21 Network Rail added:

[8] See Appendix A at A.83 and following,

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

4.22 Buyers told us that, whilst it was not for the law to 'molly-coddle' businesses, change was necessary. Under the present system, a buyer might act reasonably and to the best of its ability but still the insurer may be entitled to refuse the claim.

4.23 One financial institution said that, at present, it has little confidence in the outcome of any claim. Another said that insurance is sometimes viewed as "a right to sue an insurance company rather than a clear contract to pay after a given event". Network Rail added that policyholders are forced to rely on goodwill:

> Too often a policyholder will be reliant on the insurer's goodwill in order that a claim is not rejected due to a technical breach of the current law. The legal basis of insurance contracts needs a clear shift.

4.24 Most buyers are risk adverse; that is why they buy insurance. They want to pass the risk of innocent and reasonable non-disclosure to the insurer, even at the cost of a small increase in the premium. The Construction Industry Council wrote; "if that proves to be the case, so be it; more effective insurance arrangements should come at a price".

The Airmic survey

4.25 The Airmic (the risk managers' association) represents the insurance buyers and risk managers for the largest companies. Their membership includes around three-quarters of the UK FTSE 100 group of companies. They strongly supported a change in the law.

4.26 In 2010, Airmic responded to increasing industry concern about the duty of disclosure by surveying its members on the topic. The survey[9] showed that presenting the risk is a major task. 75% of the Airmic members who responded spend between two and six months in preparing the information they submit to insurers. This is a considerable commitment of resource, bearing in mind that insurance is generally renewed on an annual basis. Members said that 38% of submissions for property risks exceeded 50 pages: 36% did so for casualty insurance; and 26% for directors' and officers' liability insurance. This equally places a considerable burden on underwriters who must assess the relevance of what they have been given.

[9] Airmic Non-disclosure of material information - Member Survey (2010). The survey is based on 111 responses.

4.27 Despite these efforts, approximately a third (31%) of participants stated that insurers had raised non-disclosure issues against them in the last five years. Of these, only around half reported that the claim had been resolved satisfactorily. There was also a worryingly high level of litigation: 5% of all Airmic members in the survey had been involved in litigation on the issue of non-disclosure in the last five years. Furthermore, over three quarters (77%) thought that the problem was becoming worse and that it was increasingly difficult to collect accurate, relevant information.

4.28 In response to these findings Airmic has prepared a non-disclosure guide to give members advice on how to minimise potential non-disclosure and misrepresentation problems. Airmic has negotiated with leading insurers to agree a policy term that would provide proportional remedies to insurers rather than a right to avoid in the event that members failed to disclose or misrepresented relevant underwriting information. We support these initiatives. They are not a substitute for law reform, however, as their effect will be confined to those involved.

The Mactavish Report

4.29 In early 2011, the Mactavish Group published a Report on this issue.[10] The Group interviewed over 600 policyholders and over 100 senior insurance executives. Their Report covered a wider sector of corporate Britain than represented by Airmic. The Report observed that the greatest problems were likely to be experienced by mid-sized companies with a turnover of between £50 million and £5 billion.

Poor understanding of the law

4.30 The first finding of the Mactavish Report was that buyers have little understanding of the duty of disclosure. The survey found that 87% were unaware of how onerous the duty was. Equally alarmingly, 65% demonstrated this ignorance by failing to review the information used to place their risks with insurers.

4.31 At one end of the spectrum is the response from a company secretary of a manufacturing company turning over more than £300 million:

> I've never looked at insurance law myself. I firmly put myself in the category of not having a clue.

4.32 Others might be aware of the duty of disclosure, without understanding its width or its implications. The insurance manager with a major retailer said:

[10] Corporate Risk & Insurance - The Case for Placement Reform. The Mactavish Protocols (2011). This followed an earlier Report in 2010, Mactavish Sector Research 2010 – Stage One. Cross-Sector Findings Summary. Recently, Mactavish have prepared a further Report on Risk Evolution and Insurance Reliability in the UK Manufacturing/Engineering Segment. The Report analyses risk management best practice and common areas of policy failure. It identifies particular areas of absent or weak disclosure, where businesses have failed to provide areas of information about recent changes. This includes changes to the supply chain, outsourcing, new services or shifts in contractual liability. It is expected the Report will be published later this year.

> I'm probably expressing my naivety here, but my understanding is that if something is not material to the claim it has no bearing.[11]

4.33 This is not an accurate view of the law. Under section 18(2), the issue only has to be material to the insurer in fixing the premium or deciding to take the risk. It does not have to be material to the claim which actually arises.

4.34 Ignorance of the law is of course no excuse: nor is it a reason in itself for reform. The law does, however, need to support the commercial transaction undertaken. The duty of disclosure is so counter-intuitive that many business policyholders struggle to understand it, which means that the law does not do all it could do to encourage good presentations of the risk.

Poor presentations

4.35 The second finding was that there were widespread failures to provide the material information. The Mactavish Group reviewed over 100 market submissions and conducted around 50 in-depth case studies. It concluded:

> The same weaknesses and limitations seem to crop up in almost all cases. The senior insurance personnel consulted as part of this work concurred that the weaknesses are endemic and market-wide. Of course, there is some variation in the standards of disclosure – and specific areas of error or omission – but the overall picture is consistent enough to confirm that current market standards are inadequate.[12]

4.36 The Mactavish Report made three main structural criticisms of the way submissions were presented:

(1) An excessive focus on presenting the bare facts, rather than crucial information about the context;

(2) A lack of structuring, indexing and signposting. Underwriters complained of "data dump", with submissions including much irrelevant information;

(3) A reliance on verbal briefings, which were seldom recorded.

4.37 The Mactavish Report also highlighted many examples of material omissions. These included:

(1) Cursory or inaccurate discussion of the end-use to which products are put. Companies failed to mention that apparently innocuous components may be used for risky medical, space or nuclear applications.

(2) In business interruption policies, inadequate information about single source dependency or business continuity arrangements. For example, a large UK retailer failed to mention that it had reduced the number of its suppliers and closed distribution centres. It was now dependent on fewer suppliers and centres.

[11] The Mactavish Report at p 14.

[12] The Mactavish Report at p17.

(3) There was a lack of discussion of non-core activities. For example, a manufacturing company failed to mention that it undertook sensitive contract testing work for third parties.

The role of brokers

4.38 In business insurance most transactions involve a broker. Brokers are generally the agent of the policyholder. Brokers have well established duties to advise their clients on the appropriate level of cover and to assist with the presentation of the risk to insurers.

4.39 Broker fees have fallen sharply. The Mactavish Report estimated that in 2010 fees in the mid to large corporate sector were 25-30% lower than in 2007. Mactavish also observed that insurance broker fees were low in comparison to other financial services.[13] Brokers have therefore less time to devote to visiting and understanding the client's business. There is also less understanding across the industry as to what should be included in a full presentation.

4.40 The Report summarised the position in the following terms:

> The system through which corporate insurance is purchased in the UK prioritises, above all else, low (and declining) transaction costs, i.e. brokers fees. This means relatively little time is devoted to getting the customer a reliable contract. This is understandable given the need for all businesses to keep costs in check. However it ultimately leads to a low level of contract certainty. Given that the insurance industry in its own words "sells promises", this is highly damaging for the customer.

4.41 Following the Report, brokers reaffirmed to us that there is now less time to prepare presentations. Geoffrey Lloyd, an expert witness in insurance disputes, told us of "widespread de-skilling" across both brokers and insurers, with far fewer site visits and surveys.

Soft and hard markets

4.42 In a soft market insurance is relatively cheap and insurers are keen to write business. That can result in slapdash presentations by buyers, cost cutting by brokers and over exuberant underwriting by insurers. As noted in the Mactavish Report, after many years of a soft insurance market, insurers have grown to accept lower standards in submission:

> The soft market puts underwriters under intense pressure to secure new business. They must operate with the knowledge that there are other penholders ready to write business on the back of the most meagre information in submission documents.[14]

[13] Broker placement fees typically ranged between 0.1% and 0.2% of the contingent capital arranged, whereas banks would earn between 2% and 10% of capital. The two arrangements are structurally different, however, so that any comparison between the two is crude.

[14] Mactavish Corporate Risk & Insurance - The Case for Placement Reform. The Mactavish Protocols (2011), at p 11.

4.43 In soft markets, insurers may also pay claims as a matter of goodwill, as they are keen to retain business. A theme of the Report is that many claims are paid on this basis, but that will dwindle if market conditions deteriorate.

4.44 The problems come when soft markets start to turn hard. If insurers discover that they have underpriced the risk they have taken on, they may be more inclined to raise issues of non-disclosure when a claim is made. In current market conditions, this is an increasing danger. The Mactavish Report observed that this could have serious consequences for businesses:

> If, for whatever reason, a major insurance policy fails to pay out, most firms would either struggle to raise debt to pay for the loss, or would be charged prohibitively expensive amounts to do so.

Although:

> It is worth pointing out that disputes do not necessarily mean outright refusal of claims; rather, they more often mean delays in settlement or protracted negotiations about the size of claim payments.

4.45 The Report concluded with seven practical suggestions as to how the transfer of information from the proposer through the broker to the insurer could be improved.

Responses to the Mactavish Report

4.46 Several responses confirmed that corporate buyers run the risk that claims will be disputed for reasons of non-disclosure. In a March 2011 briefing,[15] Herbert Smith commented:

> Most insurance lawyers will have no difficulty in confirming that the claims market, which was for a number of years in the second half of the last decade "quiet", has now begun to show signs of heating up....
>
> Mactavish's findings could cause some insurance buyers to be concerned that when the market correction comes and the "tide" of a relatively benign claims environment "goes out", a material number of them may be found to be swimming naked.

4.47 Airmic commented:

> Mactavish's research is thorough and convincing, and it lifts the lid on a potential crisis looming in the UK commercial insurance market. Airmic have long argued that the current legal framework for commercial insurance contracts is unsustainable. This research illustrates just how dangerous the situation can be.[16]

4.48 Zurich Global Corporate UK in their general statement said:

[15] Herbert Smith, *Perspectives on the Mactavish Report,* March 2011

[16] Mactavish Corporate Risk & Insurance – The case for placement reform. The Mactavish Protocols (2011). Industry response.

> The principles and proposals set out in the report seek to establish greater transparency between insurers, customers and brokers and this is something Zurich supports…. The protocols proposed in the Mactavish report, if widely adopted, will reinforce an underwriting ethos that is well established within Zurich.[17]

Contracting out

4.49 Section 18 of the 1906 Act is subject to freedom of contract. The parties are free to exclude or limit its effect through contractual terms. A familiar exclusion is that used in solicitors' professional indemnity insurance. To protect third parties, in England and Wales, the Solicitors Regulation Authority (SRA) requires solicitors to take out professional indemnity insurance on prescribed minimum terms. Term 4.1 of the minimum terms states that:

> The insurance must provide that the insurer is not entitled to avoid or repudiate the insurance on any grounds whatsoever including, without limitation, non-disclosure or misrepresentation, whether fraudulent or not.[18]

Few other policyholders, however, have the bargaining power to demand such an all embracing exclusion.

4.50 In the Airmic survey, around 20 respondents (18%) said that they had agreed contractual terms to limit the duty in at least some of their policies. The most common terms protected the insured in the event of an "innocent" non-disclosure, though one firm described the term it used as "a bit woolly". Three firms said that they had included terms to limit the information which needed to be disclosed to information known to the risk management or insurance department.

4.51 Airmic worked with solicitors to produce a draft clause which members could insert in their contracts. The clause was aimed primarily at ameliorating the remedy for non-disclosure. It stated that for non-fraudulent actions, the insurer would not be entitled to avoid, but would instead be bound by the contract on different terms.[19] In July 2011, an article in the Post Magazine commented that while most insurers at the Airmic conference "supported the clause in principle none have formally signed up". XL reported that they were drafting a simpler and shorter clause to achieve the "widest possible market acceptance".[20]

[17] Mactavish Corporate Risk & Insurance – The case for placement reform. The Mactavish Protocols (2011) Industry response.

[18] A similarly worded contracting out provision is a contract term within the Master Policy for Scottish Solicitors.

[19] Presented to the Airmic conference in June 2011.

[20] Chinwe Akomah, XL seeks alternative to non-disclosure clause; *Post Magazine* [28 July 2011].

4.52 Although the problems with the current law can be dealt with by contract terms, the industry has not found it easy to negotiate terms which strike a fair balance between the parties. Any negotiations on the issue of non-disclosure have the potential to generate distrust. Insurers fear that the policyholder may be concealing important information, while policyholders fear that the insurer may be finding excuses not to pay claims. Furthermore, the ability to negotiate terms depends on the policyholder having both the time and the commercial strength to do so. That leaves medium sized companies facing the full rigours of the law.

THE NEED FOR REFORM

4.53 Clearly, not all the problems within the insurance market stem from the law. The law should, however, support good market practice and encourage workable arrangements. The law on non-disclosure, as set out in the 1906 Act, has contributed to the current problems in four ways:

(1) Policyholders fail to understand it – not because the words are complex, but because the concept is counter-intuitive. Despite continual warnings, few policyholders believe that the law really expects them to second-guess what the insurer wants to know. Even if they do believe it, they have little idea of how to set about the task.

(2) Section 18 of the 1906 Act fails to clarify whose knowledge within a company is relevant, and what those who place insurance must do to gather information in order to make proper disclosure.

(3) Insurers have insufficient incentive to ask questions before underwriting a risk. The law gives the impression that insurers are entitled to write any risk, however inadequately presented, and ask questions only once a claim arises.

(4) The remedy for non-disclosure is unduly harsh. A policyholder who fails to mention a minor issue loses all benefit from the policy, even if the insurer would only have added a small amount to the premium had it known the true facts.

4.54 In Part 5, we discuss how far the law permits an insurer to raise non-disclosure issues at the claims stage, even if it failed to ask relevant questions before entering the contract. In some situations, the words of section 18 of the 1906 Act may provide insurers with a false sense of security. We think, however, that without the apparent comfort provided by section 18, insurers would have done more to guide policyholders on what should be included in a presentation, to ask questions and to make site visits.

4.55 The Mactavish Report commented that the insurers interviewed were well aware of endemic failures in presentations of the risk.[21] Yet insurers have done relatively little in reaction to this by providing guidance on what should be included in a presentation. We think the law needs to do more to encourage insurers, both individually and collectively, to improve the situation.

[21] Mactavish Corporate Risk & Insurance - The Case for Placement Reform. The Mactavish Protocols (2011) at p17.

4.56 Equally, the law should do more to encourage policyholders to make fair presentations of the risk. The clearer and better understood the law, the higher standards of presentation are likely to be.

PREVIOUS REPORTS

4.57 These criticisms of the duty of disclosure are far from new, though they have taken on a new urgency in the current economic climate. In 1957, the Law Reform Committee remarked that:

> A fact may be material to insurers … which would not necessarily appear to a proposer for insurance, however honest and careful, to be one which he ought to disclose.[22]

4.58 In 1980, the Law Commission described the duty of disclosure as far too stringent, and being "something of a trap" for the insured. It commented:

> An honest and reasonable insured may be quite unaware of the existence and extent of this duty, and even if he is aware of it, he may have great difficulty in forming any view as to what facts a prudent insurer would consider to be material.[23]

4.59 In 2001, the British Insurance Law Association (BILA) formed a sub-committee to examine those areas of insurance law causing concern within the insurance market. In 2002, BILA submitted a report to the Law Commission calling for reform.

THE "REASONABLE INSURED" TEST

4.60 All three previous reports recommended modifying a test based on what would influence a prudent insurer to a test based on what a reasonable insured would think was relevant to a prudent insurer. As we saw in Part 3, a reasonable insured test was introduced into Australian law as a result of the Insurance Contract Law Act 1984 (though it does not affect marine insurance). In 2006 Professor Merkin reported that the test was well-established,[24] though two Bills have subsequently been introduced to clarify how the reasonable insured test should be applied.[25]

[22] Law Reform Committee, Fifth Report (1957) Cmnd 62, para 3.18.

[23] Law Commission, Insurance Law: Non-disclosure and Breach of Warranty; (1980) Law Com No 104, para 9.3.

[24] R Merkin, *Reforming insurance law: is there a case for reverse transportation?* Report for the English and Scottish Law Commissions on the Australian experience of insurance law reform (2007).

[25] See Part 3, paras 3.7 and 3.8.

4.61 In the 2007 Consultation Paper, we put forward a similar test. We proposed to replace section 18(2) with a new test, based on what a "reasonable insured" in the circumstances would think was relevant to the insurer.[26] We received 60 responses on this issue, and views were split: 31 (52%) agreed and 29 (48%) disagreed.

Views in favour

4.62 Many consultees welcomed the proposed reform, saying that it would be flexible and fair in the business context. The Faculty of Advocates thought that:

> The current test of the "prudent insurer" is clearly fraught with difficulty for the insured – who is unlikely to have much insight into the mindset of an insurer – when considering what information requires to be disclosed.

4.63 The Law Society of Scotland said:

> One of the most significant advantages of this suggested approach is that it allows a court to differentiate between different types and sizes of business insured.

Problems of uncertainty

4.64 The main argument against the reasonable insured test was that it would create uncertainty. It was said that what underwriters think is material can be shown by expert evidence; but as there was no recognised "reasonable insured", judges would substitute their own version of the test. The Association of British Insurers put the point as follows:

> This would be even more arbitrary in the context of business insurance, which includes specialist markets, as the judges would have to put themselves in the shoes of a reasonable business rather than a reasonable consumer.

4.65 NFU Mutual described the proposal as "riddled with difficulties". The characteristics of the reasonable insured would:

> … change from one business to the next, according to in particular: (1) the nature and size of the business; and (2) whether or not a broker was used in the transaction. There is no single test, obtaining expert evidence will be almost impossible and the net result will be to give the trial judge a very wide discretion in each case.

4.66 One consultee queried whether the commercial "reasonable insured" could ever be satisfactorily defined. Unlike a consumer insured where reasonableness can be based on a core understanding of the general population, there is no single paradigm underlying who a reasonable commercial insured is and how it behaves.

[26] Insurance Contract Law: Misrepresentation, Non-disclosure and Breach of Warranty by the Insured; (2007) LCCP 182/SLCDP 134, at paras 5.83 and 12.31.

4.67 Even those who saw merit in the reasonable insured test expressed concern about its uncertainty. Freshfields thought that it made sense to focus on the "reasonable insured" but that "this will inevitably lead to uncertainties in the law (and increase litigation) until case law develops on this point". They thought that "there may be tensions in the courts in applying an objective standard to the subjective circumstances of an individual insured".

4.68 Kendall Freeman also noted that:

> … a large proportion of insurance disputes are dealt with by way of arbitration, rather than litigation, thus it may take a long time for a body of case law on the meaning of "reasonable insured" to build up.

Would the test protect buyers?

4.69 Airmic agreed with the reasonable insured test. Nevertheless, they expressed concern that:

> … an experienced risk manager may face a greater burden of disclosure because of doubt about the definition of "reasonable insured". AIRMIC members might be prejudiced by this rule, as being an insurance expert in a company would mean that the definition of "reasonable" would be strict and as such more evidence would need to be produced to show all reasonable endeavour was used to ascertain information for the underwriter.

4.70 Martin Bakes said that it was questionable whether the change in the test would be a significant help to the insured in making an assessment about what information they should disclose. He pointed out that the test was what was thought to be relevant to the insurer and not what was relevant to the insured.[27] What was material was still decided with reference to the insurer even though it was to be determined through the prism of what a reasonable insured might conclude. Therefore:

> The onus would still be on the insured to give disclosure of material facts. An insured would still have to form a view about what facts might be material.
>
> Accordingly the exercise that an insured would have to go through would be no different to the type of exercise that it must go through at present i.e. to consider what information would be material and to make enquiries within the business to obtain it.

[27] Martin Bakes, Pre-Contractual Information Duties and the Law Commission's Review, *Reforming Marine and Commercial Insurance Law,* (2008).

The reasonable insured test: conclusion

4.71 We accept that a "reasonable insured" test would introduce a new, unknown and untested concept in the law. The example of Australia, where reform first took place in 1984, shows that ongoing legislative adjustment may be needed. If such a test were introduced into the law of the UK it would take judges time to develop a common approach, and during this time it would be even more difficult to advise businesses about what they were expected to disclose.

THE WAY FORWARD

4.72 Our present proposals are evolutionary. They work within the framework of the current law.

4.73 We have three aims:

(1) to help clarify how policyholders are expected to go about presenting a risk, and what issues should be covered;

(2) to encourage insurers, both individually and collectively, to assist policyholders in understanding what must be disclosed; and

(3) to provide fair remedies.

4.74 Many cases set out helpful glosses on the nature of section 18 of the 1906 Act, but most have been decided on specific facts after the event with the aim of doing justice in that particular case.

4.75 In Parts 5 to 8 we draw on the best principles in the current case law. Part 5 considers what amounts to a fair presentation of the risk and when the insurer should ask questions. Parts 6 and 7 then address the issue of knowledge, looking first at what a corporate policyholder should "know or ought to know", and then at what a broker "knows or ought to know" in this context. Part 8 then considers circumstances which need not be disclosed because the insurer "knows or ought to know" them.

4.76 Finally, in Part 9 for those non-disclosures or misrepresentations which are not dishonest we propose to introduce a new system of remedies which are based on putting the insurer in the position it would have been in had it known the true facts. This will be a departure from current UK commercial insurance law, though proportionate remedies are widely used in Europe and in consumer disputes.

A full circle?

4.77 The modern law on non-disclosure and misrepresentation owes its origins to the decision in *Carter v Boehm* in 1766, which introduced the concept of good faith into insurance law. Here Lord Mansfield explained that the duties were reciprocal:

> 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 underwriter into a belief that the circumstance does not exist, and to induce him to estimate the risque, as if it did not exist.[28]

4.78 Nevertheless, on the facts Lord Mansfield found for the insured because:

(1) if the underwriter had wanted to have that type of information he should have asked for it; and

(2) a professional underwriter offering to insure the risk should have been aware of the relevant information.

4.79 Lord Mansfield said:

> There was not a word said to [the underwriter], of the affairs of India, or the state of the war there, or the condition of Fort Marlborough. If he thought that omission was an objection at the time, he ought not to have signed the policy with a secret reserve in his own mind to make it void; if he dispensed with the information, and did not think this silence an objection then he cannot make it up now, after the event.

4.80 In other words, while the proposer owed a duty of disclosure, the insurer should also have played a full part in the information gathering process. During the nineteenth century the courts lost sight of the reciprocal nature of the duty of disclosure. We propose to redress that imbalance.

QUESTIONS

The need for reform

4.81 We have concluded that the duty of disclosure causes problems in business insurance. The duty is poorly understood; it gives the impression that insurers may play only a passive role in the underwriting process; and it results in overly harsh penalties for the insured.

4.82 The law on non-disclosure and misrepresentation was codified in sections 18 to 20 of the Marine Insurance Act 1906 and has become ossified. It generates too many disputes, particularly for larger and more complex businesses. We think these sections should be amended to provide greater clarity for both policyholders and insurers.

4.83 **Do consultees agree that there is a need to reform sections 18 to 20 of the Marine Insurance Act 1906 to clarify the duty of disclosure in business insurance**?

[28] *Carter v Boehm* (1766) 3 Burr 1905 at 1909.

Small and large businesses

4.84 In practice, the duty of disclosure causes more problems for large businesses than for small businesses. In 2009 we proposed special protections for micro-businesses, but we are no longer proceeding with these proposals for the reasons set out in the Appendix. In particular:

(1) Any definition would be arbitrary, complex and difficult to apply;

(2) There is insufficient evidence of need to justify the potential costs of a special regime;

(3) The Financial Ombudsman Service is able to prevent injustice in hard cases.

4.85 We therefore conclude that any reforms should apply to all businesses, large and small.

4.86 **Do consultees agree that the same legal regime should apply to all businesses, both large and small? If consultees think that special protections should apply to smaller businesses, please provide evidence of need**.

PART 5
A FAIR PRESENTATION OF THE RISK

THE SECTION 18 DUTY

5.1 The duty of disclosure is set out in section 18(1) of the Marine Insurance Act 1906 (the 1906 Act). It states:

> (1) Subject to the provisions of this section, the assured must disclose to the insurer, before the contract is concluded, every material circumstance which is known to the assured, and the assured is deemed to know every circumstance which, in the ordinary course of business, ought to be known by him. If the assured fails to make such disclosure, the insurer may avoid the contract.

5.2 Section 18(1) makes it clear that the duty only arises "before the contract is concluded". It then introduces two problematic concepts: materiality and knowledge. First, what is meant by "every material circumstance"? Secondly how do you judge what a policyholder knows or ought to know? In this Part we focus on "material circumstance". The next Part, Part 6, considers the policyholder's knowledge.

5.3 Under section 18(2), "material" is defined in wide terms. It states:

> (2) Every circumstance is material which would influence the judgment of a prudent insurer in fixing the premium, or determining whether he will take the risk.

5.4 Section 18(3) Act then sets out four exceptions to the duty of disclosure. These are given in full in Part 2.[1] For the present purposes the most important is 18(3)(c):

> (3) In the absence of inquiry the following circumstances need not be disclosed, namely: −
>
> …
>
> (c) any circumstance as to which information is waived by the insurer;

5.5 The formulation of the test for what is material at section 18(2) is open to two criticisms:

(1) It places a heavy burden on the policyholder. The policyholder is generally not an insurer,[2] and may have little understanding of how insurers price risks. Yet the policyholder is required to understand what would influence a prudent insurer.

[1] See Part 2 at para 2.24.

[2] Although, the policyholder would be an insurer under a contract of reinsurance.

(2) It appears to allow the insurer to play a purely passive role. The words of the statute suggest that the insurer is under no obligation to ask questions or indicate what it wishes to know before forming a contract. Instead the insurer may accept the premium and, if a claim is subsequently made, ask questions at that stage. If the insurer discovers material information that the policyholder failed to disclose, then the contract can be avoided.

5.6 This view of the law is an over-simplification. Many recent statements of the law put the policyholder's duty to disclose in more limited terms. Following a long line of cases,[3] a major textbook, *MacGillivray*, summarises the case law as follows:

> [T]he assured must perform his duty of disclosure properly by making a fair presentation of the risk proposed for insurance. If the insurers thereby receive information from the assured or his agent which, taken on its own or in conjunction with other facts known to them or which they are presumed to know, would naturally prompt a reasonably careful insurer to make further inquiries, then, if they omit to make the appropriate check or inquiry, assuming it can be made reasonably, they will be held to have waived disclosure of the material fact which that inquiry would have necessarily revealed.[4]

5.7 In *WISE (Underwriting Agency) Ltd v Grupo Nacional Provincial SA*, the Court of Appeal affirmed that this was a correct view of the law. [5]

5.8 There are two elements to this test.

(1) The assured must make "a fair presentation of the risk".

(2) The insurer waives its right to information if it fails to make the enquiries a reasonably careful insurer would have made.

5.9 Since the landmark decision of the House of Lords in *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd*,[6] there is an additional requirement before an insurer can establish a non-disclosure or misrepresentation. The insurer must have been induced to enter into the contract. The test looks not at a hypothetical prudent insurer but at the actual insurer: if it had known the truth, would the insurer have entered into the contract, either at all or on different terms? If the non-disclosure would have made no difference to the decision, the insurer has no remedy. This is an important protection for the policyholder but does not appear within the statute.

5.10 Below, we look at each element in turn: first at the fair presentation test, then at waiver, and finally at inducement.

[3] See in particular *Container Transport International Inc v Oceanus Mutual Underwriting Association (Bermuda) Ltd* [1984] 1 Lloyd's Rep 476; *Cantiere Meccanico Brindisino v Janson* [1912] 3 KB 452; and *Cohen v Standard Marine Insurance Co* (1925) Comm Cas 139.

[4] Legh-Jones, Birds and Owen, *MacGillivray on Insurance Law* (11th ed 2008), 17-083.

[5] [2004] EWCA Civ 962; [2004] 2 All ER 613, [63].

[6] [1995] 1 AC 501.

5.11 We then attempt to draw the best principles from the case law and propose that the statute should be amended to give these principles legislative force. We ask consultees if they agree that this would bring greater clarity to the market and encourage insurers and policyholders to work together to improve pre-contract disclosure.

A FAIR PRESENTATION

5.12 It is now common for the courts to describe the policyholder's duty in terms of making "a fair presentation of the risk". A search of reported judgments shows that the phrase "fair presentation of the risk" has been used in at least 15 insurance non-disclosure cases in the past ten years.[7]

5.13 The "fair presentation of the risk" is a more limited concept than "every material circumstance". As a recent case puts it:

> A minute disclosure of every material circumstance is not required. The assured complies with the duty if he discloses sufficient to call the attention of the underwriter to the relevant facts and matters in such a way that, if the latter desires further information, he can ask for it. A fair and accurate presentation of a summary of the material facts is sufficient if it would enable a prudent underwriter to form a proper judgment, either on the presentation alone, or by asking questions if he was sufficiently put upon enquiry and wanted to know further details, whether to accept the proposal and, if so, on what terms.[8]

5.14 This raises the question of what information should be included in "a fair presentation". The cases suggest that the policyholder should provide some standard information, together with information about particularly unusual or special circumstances. The policyholder should also mention any particular concerns which motivated it to seek the insurance.

The need to disclose past losses

5.15 The case of *Marc Rich & Co v Portman* illustrates some of the problems which can arise from disclosure.[9] Marc Rich & Co traded in crude oil, for which they chartered ships to transport oil around the world. They were liable to pay demurrage[10] to the charterers if there was more than a set period of delay in unloading. They sought to insure themselves against this risk.

5.16 The head of the insurance department at Marc Rich & Co, Mr Gibson, gave the judge a graphic account of his experience in obtaining insurance:

7 This does not include appeals on the same case.

8 *Garnat Trading & Shipping (Singapore) Pte Ltd and Another v Baominh Insurance Corporation* [2010] EWHC 2578 (Comm); [2011] 1 Lloyd's Rep. 589, by Clarke J. The case proceeded to the Court of Appeal, and this formulation was not questioned.

9 [1997] 1 Lloyd's Rep 225.

10 This is a sum, sometimes fixed in advance, payable where there is a delay.

> Mr Gibson told me that he was surprised that the underwriters agreed terms so readily. He had expected that he would have had to answer a host of questions about Marc Rich's experience at [various ports]. He did not regard it as a matter for him to volunteer information on claims' experience or other matters until he knew what sort of questions he was going to be asked. He elaborated this by saying he did not expect to get the insurance at all because it was unusual for insurers to write a "commercial risk" such as demurrage. He had previously regarded demurrage as totally uninsurable.[11]

5.17 In fact, the insurers accepted the risk readily, without asking any questions. Following a substantial claim, the insurers sought to avoid the policy on several grounds, including the fact that Marc Rich & Co had not disclosed its previous loss experience.

5.18 At first instance, Mr Justice Longmore found for the insurers on this point. He commented:

> A presentation which makes no reference to an existing loss experience can only be fair if the losses are modest or insignificant; a prudent Underwriter will be entitled to assume that if losses exist, they are not such as to be worth mentioning.[12]

5.19 In fact, the losses were substantial. The court found that there was a material non-disclosure and the insurers were entitled to avoid the policy.

5.20 This reasoning was confirmed on appeal. The Court of Appeal held the presentation had not been fair. As Lord Justice Leggatt put it:

> In my judgment a presentation cannot be fair if there is silence as to material losses, as there was here.

5.21 He quoted with approval a statement made by Lord Justice Scrutton in 1926:

> I have always understood the proper line that an underwriter should take, except in matters that he is bound to know, is absolutely to abstain from asking any questions, and leave the assured to fulfil his duty of good faith, and to make full disclosure of all material facts without being asked.[13]

5.22 The court also considered whether the insurer had waived information about previous losses by not asking about them. Lord Justice Leggatt held that it had not:

[11] [1997] 1 Lloyd's Rep 225 at p 299.

[12] [1996] 1 Lloyd's Rep 430 at 442-444.

[13] *Greenhill v Federal Insurance Co Ltd* (1926) 24 Lloyd's LR 383 at 391; [1927] 1 KB 65.

> An insurer cannot waive a class of information he does not know exists. That requires a fair presentation of the risk. It is obvious that a presentation cannot be fair if unusual facts are not disclosed. The insurer is entitled to assume the fairness of the presentation. Without it he cannot sensibly be said to refrain from asking questions. He must be on notice of the existence of information before he can be said to waive it.[14]

5.23 We are not sure that it is right to say that information about previous loss is so unusual that an insurer cannot be expected to ask questions about it. For many types of insurance, insurers routinely ask about previous losses. Indeed, in many jurisdictions the policyholder is not required to disclose this information in the absence of questions.[15]

5.24 The policy justification for requiring the policyholder to volunteer information about previous losses is not that the issue is unusual but that it is so common the insurer will need it and the policyholder should know to include it. It is administratively simpler in the large commercial market to expect the policyholder to present the risk. The case is, however, a salutary lesson for any Head of Insurance who, like Mr Gibson, fails to volunteer information because he expects to be asked questions.

Other standard information which should be disclosed

5.25 There are several other types of standard information which the courts have held should be included in a fair presentation of the risk.

5.26 First the policyholder should disclose the criminal convictions of directors or senior staff.[16] This is not because criminal records are particularly unusual. The figures show that well over a quarter of adult males between the ages of 18 and 52 in England and Wales have at least one criminal conviction for non-trivial offences.[17] It is however accepted that criminal convictions raise issues of moral

[14] [1997] 1 Lloyd's Rep 225, at 234.

[15] See Part 3.

[16] For example in *ERC Frankona Reinsurance v American National Insurance Company* [2005] EWHC 1381 (Comm) the reinsured failed to disclose that its managing agents' Chief Operating Officer had a criminal record. In *Inversiones Manria SA v Sphere Drake Insurance Co Plc* (The Dora) [1989] 1 Lloyd's Rep 69 at 94-95, the policyholders insured a yacht without mentioning that the skipper had a criminal record.

[17] Official estimates show that in 2006, 28.2% of adult males aged between 18 and 52 had a criminal conviction for a non-trivial offence. This includes all indictable and triable-either-way offences plus the more serious summary offences such as assault and criminal damage. The figures include serious driving offences (driving whilst disqualified, driving with excess alcohol, dangerous driving and driving without insurance) but not less serious offences such as careless driving. The equivalent proportion of women aged 18 to 52 is 6.5%. See Ministry of Justice Statistical Bulletin "Conviction histories of offenders between the ages of 10 and 52" (July 2010) at http://www.justice.gov.uk/downloads/statistics/mojstats/criminal-histories-bulletin.pdf. Equivalent statistics in relation to Scotland do not appear to be available.

hazard. Where the conviction is not spent within the terms of the Rehabilitation of Offenders Act 1974,[18] the insurer is entitled to be told about it.

5.27 Similarly, the courts have held that information about any insolvency associated with the policyholder should be disclosed. An example is *Sugar Hut Group Ltd & Ors v Great Lakes Reinsurance (UK) Plc*.[19] The claimants were a group of companies which ran four nightclubs. Three old companies previously associated with the clubs had gone into administration due to financial difficulty. The court found that this was a material fact which should have been disclosed. As it was not disclosed, the insurers were entitled to avoid the contract. Mr Justice Burton held that the insurers had not waived this information by asking more limited questions about the trading history of the insured companies. He pointed out that the proposal form specifically invited the policyholder to disclose "*any other facts not covered by the questions in this form*".[20]

5.28 Again, insolvency and bankruptcy are common: in 2011, in England and Wales, there were 21,843 corporate insolvencies[21] and 119,850 individual insolvencies.[22] In Scotland, the provisional figure for corporate insolvencies in 2011 is 1,530;[23] and for the financial year 2010/2011, there were 19,423 personal insolvencies.[24]

5.29 It appears that some categories of standard information are so fundamental that the policyholder should include them in any presentation of the risk. Below we consider ways in which more can be done to clarify these categories.

Special or unusual facts

5.30 The policyholder must also disclose any special or unusual facts which increase the risk. In *CTI v Oceanus Mutual Underwriting Association (Bermuda) Ltd*, Lord Justice Kerr put the point as follows:

[18] The Rehabilitation of Offenders Act 1974 provides that some convictions can be ignored after a period of rehabilitation during which there has been no further conviction. The period varies according to the sentence given. Once the period has expired the conviction is spent and need not be disclosed; see s 4. The Act may be subject to amendment by the Rehabilitation of Offenders (Amendment) Bill, although any such amendment will apply only to England and Wales.

[19] [2010] EWHC 2636 (Comm), [2011] Lloyd's Rep IR 198.

[20] Above at [498]. See also *Doheny & ors v New India Company Ltd* [2004] EWCA Civ 1705.

[21] This includes: compulsory liquidations, creditors' voluntary liquidations, receiverships, administrations and company voluntary arrangements: see Insolvency Service, Insolvency Statistics (February 2012) at http://www.insolvencydirect.bis.gov.uk/otherinformation/statistics/201202/index.htm

[22] The total includes 41,845 bankruptcies, 49,056 Individual Voluntary Arrangements and 28,949 Debt Relief Orders.

[23] http://www.insolvencydirect.bis.gov.uk/otherinformation/statistics/201202/index.htm#tables.

[24] http://www.aib.gov.uk/scottish-insolvency-statistics-quarter-3-2011-12. This includes bankruptcies and 7,980 protected trust deeds.

> The doctrine of waiver cannot be applied to undisclosed facts which are unusual or special, so that their non-disclosure distorts the presentation of the risk. In such cases, the underwriter is not put on enquiry about the existence of such facts.[25]

5.31 Lord Justice Kerr gave *Greenhill v Federal Insurance Co Ltd* as an example: here the policyholder insured cargo across the Atlantic from Halifax to Nantes, without mentioning that it had already suffered injury before it arrived in Halifax.

5.32 The same point was made in 1913, when Mr Justice Scrutton commented that time policies on ships differ so much that a reinsurer should not presume that they contained any particular terms.[26] If the reinsurer wants to know the terms and conditions, it should ask. But this does not apply where:

> It is quite clear that the policy may be for such an extraordinary risk, as where the ship may have liberty to do unusual or dangerous things, that there may be clauses in the original policy which an underwriter offering ought to disclose because they are so out of the usual that a reinsuring underwriter would not expect them.

5.33 There are many examples of special and unusual facts which a policyholder should realise would be material to the insurer. In taking out life insurance,[27] one should normally disclose a death threat and we would expect the same principle to apply, for example, where a business received an arson threat. Again, a business would be expected to mention that it had recently acquired an explosives factory; or that (in product liability insurance) its products were used in nuclear power plants.

Concerns which led to the placement of the insurance

5.34 It is also established that a policyholder should disclose any general concerns which led to the insurance being sought.

5.35 In *Aiken v Stewart Wrightson Members Agency Ltd*[28] the claimants were Lloyd's names who used managing agents, PUM, to enter a contract of reinsurance. The reinsurers avoided the reinsurance on the grounds that PUM had failed to disclose the full extent of the claimant's exposure to asbestosis claims, and this decision was upheld in arbitration. The names then claimed damages for breach of contract and negligence against PUM for this non-disclosure, among other things.

[25] [1984] 1 Lloyd's Rep 476 at 498.

[26] *Property Insurance Co Ltd v National Protector Insurance Co Ltd* (1913) 108 LT 104, at 106.

[27] *Leen v Hall* (1923) 16 Lloyd's LR 100, KBD.

[28] [1995] 3 All ER 449, [1995] 2 Lloyd's Rep 618. This decision was confirmed on appeal although it should be noted that the appeal did not relate to the issue of non-disclosure: [1996] 2 Lloyd's Rep 577.

5.36 On the facts, the court found that the underwriter and deputy underwriter at PUM had a general concern about exposure to asbestosis claims in light of recent US litigation. In relation to what should have been disclosed, the Court held that:[29]

> … because of the rule that the opinion of the particular assured as to the materiality of a fact is not the test to be applied, it was the duty of PUM as prudent managing agents … to consider with care what required to be disclosed to a prospective reinsurer. This duty applied especially to the matters which were giving PUM concern and were arguably, if not obviously, material to the prudent insurer; in particular, the mounting claims for asbestosis and DES which were the reason why the reinsurance was sought in the first place.

5.37 It is clear that a policyholder should disclose any particular concerns about the risk which led to the insurance being sought.

WAIVER

The need to ask questions

5.38 Under the Marine Insurance Act 1906, the duty of disclosure is limited by section 18(3), which sets out four types of circumstance which need not be disclosed. In particular, section 18(3)(c) states that the insured need not disclose:

> Any circumstance as to which information is waived by the insurer;

5.39 In most legal contexts, waiver is a relatively narrow doctrine, which applies where a party makes an unequivocal representation in full knowledge of the facts. In this context, the courts have developed the concept of waiver in a specialist way. It has been used to prevent an insurer from refusing a claim where the policyholder presented the risk fairly, in a way which would prompt a reasonably careful insurer to make further enquiries, but the insurer failed to make appropriate enquiries.[30]

5.40 Lord Justice Rix elaborated on the principle as follows:

> Ultimately, it seems, the question is: Has the insurer been put fairly on inquiry about the existence of other material facts, which such inquiry would necessarily have revealed?[31]

[29] [1995] 2 Lloyds's Rep 618 at 643.

[30] The Scots law position on waiver is similar; see Reid & Blackie, *Personal Bar* (2006), pp 238 – 242.

[31] *WISE (Underwriting Agency) Ltd v Grupo Nacional Provincial SA* [2004] EWCA Civ 962; [2004] 2 All ER 613, [64] by Rix LJ.

5.41 This test is an objective one, applying the standard of a reasonably careful insurer. Lord Justice Rix described this hypothetical insurer as being "neither a detective on one hand nor lacking in common sense on the other", noting that "mere possibilities will not put him on inquiry".[32]

5.42 This doctrine may be illustrated with some examples. In *Cohen v Standard Marine Insurance Co*, the object of the policy was an obsolete battleship which had been purchased for scrapping.[33] The ship was to be towed from England across the North Sea to Germany and then broken up. During the voyage, the vessel was abandoned by the tugs and stranded on the Dutch Coast where it became a constructive total loss. The insurers denied liability on the grounds that the policyholder had failed to disclose the fact that the vessel had no steam power of its own. Mr Justice Roche held that the insurer must be presumed to know that a dismantled warship which needed a tow was not likely to have her own sources of power. By failing to ask questions about whether the ship had its own source of power, the insurers had waived disclosure about this.

5.43 A more recent example is *Garnat Trading & Shipping (Singapore) Pte Ltd and Another v Baominh Insurance Corporation*.[34] At first instance Mr Justice Clarke found that the policyholder had disclosed the relevant information on the wind and wave height limitations that their floating dock could withstand. He commented, however, that even if the policyholder had not disclosed this information, a reasonable insurer would surely inquire into such matters. Failure to do so would amount to waiver of the information. The Court of Appeal upheld his findings.

How far must the insurer ask questions?

5.44 There is discussion within the case law about how often the insurer is obliged to ask questions. In some formulations, it has been suggested that issues of waiver arise rarely, and only after the policyholder has shown that it made a fair presentation of the risk. This was the view taken by Mr Justice Hobhouse in *Iron Trades Mutual v Compania de Seguros*:

> If a proposer has made a fair presentation of the risk, he has discharged his duty; if he has not, then a failure by an insurer to inquire will not relieve the proposer of his duty to make proper disclosure.[35]

5.45 By contrast, in *WISE (Underwriting Agency) Ltd v Grupo Nacional Provincial SA*, Lord Justice Rix suggested that there is a more extensive doctrine, "founded on the concept of fairness":

[32] Above, at [64].

[33] (1925) Comm. Cas. 139.

[34] [2010] EWHC 2578 (Comm); [2011] 1 Lloyd's Rep 589.

[35] [1991] ReLT 213, at 224.

> It would not in my judgment be fair to castigate a presentation as unfair and thus put an assured in peril of the draconian remedy of avoidance where an insurer had waived the relevant information.[36]

5.46 Thus the requirement to ask questions arises not simply from the doctrine of waiver, as set out in section 18(3), but also from the mutual duty of good faith.

5.47 The doctrine of good faith was first set out in 1766, in *Carter v Boehm*, where Lord Mansfield was fully alive to the danger that insurers could use omissions in the presentation of the claim to justify taking premiums and then refusing claims. As Lord Mansfield explained:

> The underwriter, here, knowing the governor to be acquainted with the state of the place; knowing that he apprehended danger, and must have some ground for his apprehension; being told nothing of either; signed this policy, without asking a question. If the objection 'that he was not told' is sufficient to vacate it, he took the premium, knowing the policy to be void; in order to gain, if the alternative turned out one way; and to make no satisfaction, if it turned out the other: he drew the governor into a false confidence … If he thought that omission an objection at the time, he ought not to have signed the policy with a secret reserve in his own mind to make it void; if he dispensed with the information, and did not think this silence an objection then; he cannot take it up now, after the event.[37]

5.48 These different approaches to the insurer's duty to ask questions can be illustrated by the facts in *WISE*. The policyholder had taken out a policy on a consignment of goods to be delivered to a retailer in Cancun, Mexico. Due to a mistranslation from the Spanish, the slip presented to the reinsurers in London described the goods as including "clocks", whereas in fact it concerned a large quantity of Rolex watches.[38] The reinsurers tried to avoid the contract on the ground that they would not have insured such a high theft risk. The policyholder argued that the reinsurer had waived disclosure by failing to ask further questions.

5.49 In the Court of Appeal, the majority (Lord Justice Longmore and Lord Justice Peter Gibson) held that the insurer was entitled to take the description of "clocks" on the slip at face value. The fact that the consignment was for watches was a material fact which had not been disclosed, and the reinsurers were entitled to avoid the contract.

[36] [2004] EWCA Civ 962 at [46].

[37] (1766) 3 Burr 1905 at 1918/1919.

[38] The Spanish word "relojes" can mean either clocks or watches.

5.50 By contrast, Lord Justice Rix felt that the idea that a Cancun retailer would sell such large quantities of valuable clocks was so unlikely that it should have prompted the reinsurers to ask obvious questions:

> There is nothing special or unusual about a Cancun retailer such as Perfumeria selling watches, even valuable branded watches, and it was not suggested that there was. On the contrary, what would have been special, unusual, indeed to my mind extraordinary, is for Perfumeria to have been selling each year millions of dollars of valuable clocks.[39]

5.51 Lord Justice Rix continued:

> Where a proposer for insurance makes an error in the translation of his presentation, but the error, against the background of the trade, begs a simple question (and I would say an obvious one) and does so in circumstances where the insurer knows (but the proposer does not) that he would never be prepared to insure the goods in question (here watches) but keeps that information to himself, I think it unfair of the insurer to say that he has been dealt with unfairly and is entitled to treat his contract as something he can avoid.[40]

The current state of the law

5.52 In addition to *WISE*, other cases establish that an insurer is entitled to take the information presented to it at face value.

5.53 This can be illustrated by the case of *CTI v Oceanus*. The policyholders insured damage to their containers, and the brokers presented the risk to the insurer by relying on summaries which they had prepared of claims rates under earlier policies. These rates turned out to be highly inaccurate. The brokers had then left the full placing file with the insurers, which contained lengthy policy documents from which the actual rates could have been ascertained.

5.54 The court found that there was nothing in the brokers' presentation which would have prompted a reasonable insurer to make further enquiries. The insurer was entitled to take the summaries at face value, and no waiver arose. As Lord Justice Parker put it:

> So long as [the] summary is fair, the insurer cannot complain that the full details of the experience were not disclosed. He must however be entitled to assume that the summary is fair. From this follows that, if he then proceeds to negotiate on the basis of the summary without enquiry as to its accuracy, he waives nothing. He can assume both that it is accurate as far as it goes and that, if it covers only part of the past experience, there is nothing in the part omitted which would vitiate the summary.[41]

[39] [2004] EWCA Civ 962 at [65].

[40] Above at [77].

[41] [1984] 1 Lloyd's Rep 476, at 511- 512.

5.55 On the other hand, the insurer "cannot shut his eyes to obvious incompleteness and then complain of his bargain made in ignorance of the whole story". The insurer will be taken to have waived information if "through negligence or stupidity or inexperience or pigheadedness" he does not "pursue enquiries which a prudent underwriter would have pursued".[42]

Limited questions

5.56 The doctrine of waiver can be used to curtail the duty of disclosure in several other ways. In particular, an insurer who asks an expressly limited question may be taken to indicate that it has no interest in information which falls outside the scope of that question. Thus, if the insurer asks whether the policyholder has suffered any losses in the last three years, it may be implied that the insurer is not interested in losses occurring before that period of time.

5.57 In *Doheny v New India Assurance*, Lord Justice Longmore outlined the test as follows:

> Whether or not such a waiver is present depends on a true construction of the proposal form, the test being, would a reasonable man reading the proposal form be justified in thinking that the insurer had restricted his right to receive all material information, and consented to the omission of the particular information in issue?[43]

5.58 This doctrine can be illustrated with some examples.[44] In *Roberts v Plaisted*,[45] the Court of Appeal held that the insurer's proposal form did not require the policyholder to disclose that it was running a discotheque in its hotel. The proposal form asked the policyholder to select from several options as to how the premises were being occupied, including "hotel", "casino" and "club". Having selected "hotel", the policyholder was then directed to a limited number of express questions. As the insurer's detailed proposal form did not provide space for the discotheque to be disclosed even though hotels often include discotheques on their premises, the insurer was found to have waived such disclosure.

5.59 In *Cape Plc v Iron Trades Employers Insurance Association Ltd*,[46] the insurer attempted to avoid the policyholder's liability policy on the basis that the policyholder had failed to disclose mesothelioma claims by two employees. The policyholder was a major manufacturer of asbestos products. Mr Justice Rix held that since the insurer knew that such claims were endemic in the industry and had not required pneumoconiosis exposure to be separately disclosed, it had waved separate disclosure of mesothelioma liability. At the time the existence of mesothelioma as a separate disease caused by exposure to asbestos was widely

[42] Above, by Stephenson LJ at 529 for those non-disclosures or misrepresentations which are not dishonest.

[43] [2004] EWCA Civ 1705, [2005] Lloyd's Rep IR 251 at[19].

[44] See also *O'Kane v Jones* [2005] Lloyd's Rep IR 174, where express questions on maintenance were held to waive further information potentially affecting the maintenance of the vessel, including the insured's financial position.

[45] [1989] 2 Lloyd's Rep 341.

[46] [2004] Lloyd's Rep IR 75.

known, not only within the industry but by the general public. Moreover, the insurer had extensive experience as an insurer in this industry.

5.60 It is important to note, however, that these cases all involve specific and limited information. The courts have not been willing to accept waiver arguments in cases in which the category of information supposedly waived has been too wide or difficult to define. Thus, in *Synergy Health (UK) Ltd v CGU Insurance Plc and others*, a request to fill out a Declaration of Material Facts covering moral hazard (such as convictions and bankruptcies) was found not to obviate the obligation to disclose the unrelated fact that an intruder alarm had not been installed on the premises.[47]

THE INDUCEMENT TEST

5.61 As we discussed in Part 2, in *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd*, the House of Lords held that section 18 of the Marine Insurance Act 1906 (the 1906 Act) imposed a two part test:[48]

> First, a circumstance must be "material" in the sense that it would influence a hypothetical prudent insurer in assessing the risk. The influence need not necessarily be decisive.
>
> Secondly, an insurer may only avoid a contract for misrepresentation of a material circumstance if it was induced by the misrepresentation to enter into the policy on the relevant terms. This looks at the actual insurer in question, not a hypothetical insurer in the market.

5.62 Following *Pan Atlantic*, the courts have upheld and developed the inducement test. It is now "settled law" that the insurer must show that had it known the full facts, it would not have not entered into the contract, either at all or on different terms.

5.63 In *Pan Atlantic*, the court thought that there was a "presumption of inducement". In other words, the court would presume there was a causative effect between the non-disclosure and the making of the policy unless it could be demonstrated otherwise. As Lord Mustill observed:

> As a matter of common sense […] even where the underwriter is shown to have been careless in other respects the assured will have an uphill task in persuading the court that the withholding or misstatement of circumstances satisfying the test of materiality has made no difference.[49]

[47] [2003] EWHC 3470 (Comm), [2004] 1 Lloyd's Rep. 389.

[48] [1995] 1 AC 501. The case mainly concerns non-disclosure, but the tests apply equally to misrepresentation.

[49] Above, at 551.

5.64 Subsequent cases, however, have required insurers to prove that they would have acted differently had they known the full facts. In *Assicurazioni Generali SpA v Arab Insurance Group (BSC)*,[50] Lord Justice Clarke observed that the presumption of inducement could only be used where an underwriter was unable to provide evidence. He noted:

> In all circumstances I would summarise the relevant principles of inducement in this context in this way:
>
> (i) In order to be entitled to avoid a contract of insurance or reinsurance, an insurer must prove on the balance of probabilities that he was induced to enter into the contract by a material non-disclosure or by a material misrepresentation.
>
> (ii) There is no presumption of law that an insurer or reinsurer is induced to enter in the contract by a material non-disclosure or misrepresentation.
>
> (iii) The facts may, however, be such that it is to be inferred that the particular insurer or reinsurer was so induced even in the absence of evidence from him.
>
> (iv) In order to prove inducement the insurer or reinsurer must show that the non-disclosure or misrepresentation was an effective cause of his entering into the contract on the terms on which he did. He must therefore show at least that, but for the relevant non-disclosure or misrepresentation, he would not have entered into the contract on those terms. On the other hand, he does not have to show that it was the sole effective cause of his doing so.

5.65 Some recent cases have looked at the insurer's evidence of inducement.[51] As Mr Justice Colman noted in *North Star Shipping Ltd*, "such evidence has to be rigorously tested by reference to logical self-consistency, and to such independent evidence as may be available".[52]

5.66 *Synergy Health (UK) Ltd v CGU Insurance and ors* is a recent example.[53] The claimant wrongly indicated that intruder alarms had been installed, though the parties accepted that this was an innocent "comedy of errors". After a fire two years later, the insurers sought to avoid for material misrepresentation about the intruder alarms, among other things. Mr Justice Flaux on scrutinising the underwriter's evidence, looking at the longstanding relationship between the parties and taking into account the fact that the insurer viewed the insured as a

[50] [2003] Lloyd's Rep IR 131.

[51] See for example *Drake Insurance Plc (In Provisional Liquidation) v Provident Insurance Plc* [2003] EWCA Civ 1834; [2004] Lloyd's Rep IR 277, where the Court of Appeal found that the insurer had failed to show that a different outcome would have followed had the risk been presented fairly.

[52] *North Star Shipping Ltd v Sphere Drake Insurance Plc* [2006] EWCA Civ 378; [2005] 2 Lloyd's Rep 76.

[53] *Synergy Health (UK) Ltd v CGU Insurance PLC and others* [2010] EWHC 2583 (Comm).

well-managed risk concluded that it was unlikely that the insurer would have acted differently had the mistake not been made.[54]

5.67 This contrasts with the decision in *Sugar Hut Group Ltd v Great Lakes Reinsurance (UK) Plc*.[55] On the facts, the judge found that "there was no sign whatever of any over-enthusiasm" by the insurers to accept the risk,[56] and the insurers were entitled to avoid the policy for non-disclosure.

PROPOSALS FOR REFORM

5.68 The law has developed considerably since 1906. In many respects, the words of the Marine Insurance Act 1906 no longer reflect the scope of the insured's duty to disclose.

5.69 In Part 4, we outlined the growing evidence that the duty of disclosure does not work effectively. Even large corporate policyholders do not understand the full extent of their duty, leading to large numbers of disputes over non-disclosure, and extensive litigation on the issue. There are also widespread complaints that the law encourages unduly passive underwriting. In a soft market, insurers may accept premiums on the basis of inadequate information, and then re-open the issue should a claim arise.

5.70 We think that both insurers and policyholders need to work together to provide more guidance on what should be disclosed. There is a particular need to clarify what information should be volunteered to insurers, and what needs to be disclosed only if questions are asked. To this end, we think it would be helpful to include some of the best principles from the current case law within the statute.

5.71 We propose to retain the essential elements of section 18(1) of the 1906 Act. These are that the duty to disclose arises before the contract is concluded; that the policyholder must disclose material circumstances; and that the duty is confined to information which the policyholder knows or ought to know. We think, however, that it would be useful to clarify the meaning of "material circumstances" and what an insured knows or ought to know in legislation.

5.72 In this Part we have analysed the case law on material circumstances. It establishes that an insured must disclose every material circumstance which is required to provide a fair presentation of the risk. This includes:

(1) Any unusual or special circumstances which increase the risk;

(2) Any particular concerns about the risk which led to the insurance being placed;

(3) Standard information which market participants generally understand should be disclosed.

[54] Above, at 193.

[55] *Sugar Hut Group Ltd v Great Lakes Reinsurance (UK) Ltd Plc* [2010] EWHC 2636.

[56] Above at [29].

5.73 Of these three categories, the final one causes the greatest concern. It is generally understood that proposers should mention information about previous losses and the non-spent criminal convictions or recent insolvency of directors. Beyond this limited list, however, the category becomes vague. The Mactavish research suggests that, in product liability policies, proposers should mention the end use to which the product is put, and in business interruption policies, they should mention any single source dependency. The research noted, however, that there was an endemic failure to include this type of information.[57]

5.74 We think it would be helpful for insurers and policyholders to work together to develop guidance and protocols over what a standard presentation of the risk should include. Different protocols could cover different types of insurance. Different protocols could even cover the same type of insurance, with policyholders declaring which protocol they had followed in presenting the risk.

5.75 We think that a test based on established market understanding would encourage initiatives of this type. Where an insurer could show that it had not been told information which the guidance specifically stated should be included, the insurer would find it easy to show that the risk had not been fairly presented.

5.76 We also think that it would be helpful to specify that where the insurer receives information which would prompt a reasonably careful insurer to make further enquiries, then, if the insurer fails to make appropriate enquiries, it does not have a remedy for non-disclosure of any fact which those enquires would have revealed. We think that this is such an important doctrine that it needs to be specifically mentioned in statute, rather than simply seen as part of a more general doctrine of waiver.

5.77 As we have seen, the law of waiver is also used in other contexts. For example, an insurer who asks limited questions may waive information which falls outside the scope of that question. We think these rules are well understood and can be left to the courts to develop. We propose to retain section 18(3)(c) so that the policyholder need not disclose "any circumstances as to which information is waived by the insurer", and to leave these developments to the courts.

5.78 **Do consultees agree that:**

(1) the essential elements of section 18(1) of the Marine Insurance Act 1906 should be retained, so that before entering into an insurance contract, a business policyholder should disclose every material circumstance which it knows or ought to know; but

(2) that the concepts of material circumstance and knowledge should be clarified in legislation?

[57] Corporate Risk & Insurance - The Case for Placement Reform. The Mactavish Protocols (2011) at p 18.

5.79 **In particular, should legislation specify that;**

(1) a material circumstance is a circumstance required to provide a fair presentation of the risk?

(2) A fair presentation of the risk should include:

(a) Any unusual or special circumstances which increase the risk;

(b) Any particular concerns about the risk which led the policyholder to seek insurance;

(c) Standard information which market participants generally understand should be disclosed?

(3) Where the insurer receives information which would prompt a reasonably careful insurer to make further enquiries, an insurer who fails to make appropriate enquiries should not have a remedy for non-disclosure of any fact which those enquires would have revealed?

5.80 **Do consultees agree that these principles would encourage insurers and policyholders to work together to improve pre-contract disclosure?**

5.81 **Do consultees agree that other aspects of the doctrine of waiver can be left to the courts?**

Writing the inducement test into legislation

5.82 For consumer insurance, the Consumer Insurance (Disclosure and Representations) Act 2012 gives the inducement test statutory form. Section 4(1) states that an insurer only has a remedy for a misrepresentation if, "before a consumer insurance contract was entered into or varied" the insurer "shows that without the misrepresentation, that insurer would not have entered into the contract (or agreed to the variation) at all, or would have done so only on different terms".[58]

5.83 In business insurance law, the inducement test is already an important part of the law of disclosure and misrepresentation, and we intend to preserve this. Given how significant the inducement test is under current law, there is a strong case that it should be included on the face of the legislation. We think that the opportunity should be taken to include the inducement test within the statute.

5.84 **Do consultees agree that:**

(1) If sections 18 to 20 of the Marine Insurance Act 1906 are to be amended the opportunity should be taken to include the inducement test within the statute?

[58] 2012 Act, s 41(1)(b).

(2) The statute should provide that to obtain a remedy for non-disclosure or misrepresentation, the insurer must show that without the non-disclosure or misrepresentation it would not have entered into the contract at all, or would have done so only on different terms?

PART 6
THE POLICYHOLDER'S KNOWLEDGE

THE PROBLEM

6.1 As we have seen, before entering an insurance contract, a business policyholder must disclose every material circumstance which it knows or is deemed to know. The duty is set out in section 18(1) of the Marine Insurance Act 1906 (the 1906 Act), which uses two important concepts. The first is the concept of "a material circumstance", which we discussed in Part 5. The second is that of knowledge – what the policyholder knows or is deemed to know. This Part considers what is meant by knowledge in this context.

6.2 The knowledge test is an important part of the duty of disclosure. Section 18(1) of the 1906 Act puts it in the following words. The assured must disclose every material circumstance

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

6.3 In other words, a business taking out insurance must disclose material facts which it knows or which it ought to know "in the ordinary course of business". However, that leads to difficult questions: whose knowledge is relevant and what investigations must it carry out? Unfortunately, the law is confused. As we explore below, the major textbooks have expressed different views and many business policyholders have asked for greater clarity.

6.4 The issue is particularly difficult where the policyholder in not an individual (or "natural person") but an organisation given legal status (or "legal personality"). A typical example would be a company or limited liability partnership[1], but the concept also includes corporate bodies created by statute, for example the Olympic Delivery Authority.[2] While deciding what an individual knows is a matter of fact, deciding what an organisation "knows" is a legal construct. Below we refer to business policyholders who are organisations rather than individuals as "corporate policyholders".

6.5 Here we start by discussing the knowledge requirement under section 18 of the 1906 Act. We describe the current law, to draw the best principles from the many cases on this issue. We then propose that to provide certainty these principles should be written onto the face of the statute. We ask for views.

6.6 We then provide a brief discussion of the implicit knowledge requirement under section 20 of the 1906 Act. We think that it would be simpler and easier to apply the same knowledge requirement to both section 18 and section 20.

[1] The status of general partnerships is more complex. Partnerships are recognised as having legal personality in Scotland, but not in England and Wales (though for some practical purposes they are treated as it they did have legal personality). For further details, see Law Commission and Scottish Law Commission, Partnership Law (Law Com No 283; Scot Law Com No 192) (2003).

[2] Established by the London Olympic Games and Paralympic Games Act 2006, s 3.

KNOWLEDGE UNDER SECTION 18: A TWO-PART TEST

6.7 There are two elements to understanding what a corporate policyholder knows or ought to know:

(1) Whose knowledge is relevant: that is, which individuals within a company are considered to represent what the company knows? (the attribution question).

(2) How does one judge what these people ought to know? How rigorously should they investigate issues, and by what standards should they be judged? (the constructive knowledge question).

6.8 In *PCW Syndicates v PCW Reinsurers*,[3] Lord Justice Saville explained that these two tests were "quite different":

> The first question is whether and to what extent [the corporation] has attributed to it the knowledge of actual persons of material circumstances, ie their awareness of those circumstances. If the knowledge is attributed then the corporation in law is aware of those circumstances. If no such awareness is attributed then the next question is whether the deeming provisions of section 18 apply. In the case of a corporation the test is again whether there are natural persons who ought in the ordinary course of business to know the material circumstances and whether the deemed (ie constructive) knowledge of those persons is to be attributed to the corporation. [4]

6.9 Although the questions are distinct, they are inherently linked. If one looks only at the knowledge of a limited group of people, the law needs to consider whether those particular people carried out a reasonable investigation. If the law looks at the knowledge of hundreds (or even thousands) of employees, the test is only manageable if one curtails the test to actual knowledge. It is impossible to disclose all the circumstances which any one of a thousand people ought to have known.

6.10 Below we consider each test in turn.

WHOSE KNOWLEDGE SHOULD BE DISCLOSED?

6.11 Where a natural person seeks insurance, the issue of knowledge is relatively straightforward: as Lord Justice Staughton put it, "the actual knowledge of a natural person means what it says – he knows what he knows".[5]

6.12 Where a corporation seeks insurance, however, the position is more complex. The issue is not unique to insurance law: it arises frequently within the general law, and section 18 of the 1906 Act must be interpreted against that background.

[3] [1996] 1 WLR, 1136; [1996] 1 All ER 774, discussed further below.

[4] Above at 809 a –c.

[5] *PCW Syndicates v PCW Reinsurers* [1996] 1 WLR, 1136; [1996] 1 All ER 774 at 779 j.

Attributing knowledge: general legal principles

6.13 The traditional approach to attributing knowledge within a corporation is to identify "the directing mind and will" of that corporation. In some cases, however, this is too narrow. For example, when a supermarket sells a video classified as "18" to a 14 year old, it is clearly the knowledge of the sales clerk rather than the board which is relevant.[6] The courts have therefore developed a broader test, based on the purpose of the relevant statute or regulation.

Directing mind and will

6.14 In *Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd*, Viscount Haldane LC explained the "directing mind and will" test as follows:

> A corporation is an abstraction. It has no mind of its own any more than it has a body of its own; its active and directing will must consequently be sought in the person of somebody who for some purposes may be called an agent, *but who is really the directing mind and will of the corporation*, the very ego and centre of the personality of the corporation.[7]

6.15 In *HL Bolton (Engineering) Co Ltd v TJ Graham & Sons Ltd*, Lord Denning distinguished between a company's directors and managers and other employees:

> Some of the people in the company are mere servants and agents who are nothing more than hands to do the work and cannot be said to represent the mind or will. Others are directors and managers who represent the directing mind and will of the company and control what it does. The state of mind of those managers is the state of mind of the company and is treated by the law as such.[8]

6.16 Simply holding a managerial position, however, may be insufficient in the context of a large company. For example, in *Tesco Supermarkets Ltd v Nattrass,* the court held that a store manager was not the "directing mind and will" of the company after hearing evidence that the company had more than 800 store managers.[9]

6.17 In most cases the "directing mind and will" is confined to the board, or the senior management team, though in limited liability partnerships it would probably include all the members. It has elements of flexibility. For example, in *Stone and Rolls Ltd v Moore Stephens* the acts of the only person beneficially interested in the company's shares were held to be attributable to the company.[10]

[6] This example was quoted by Staughton LJ in *PCW Syndicates v PCW Reinsurers* at 780e.

[7] [1915] AC 705 at 713-12 (emphasis added).

[8] [1957] 1 QB 159 at 172.

[9] [1972] AC 153.

[10] [2009] UKHL 39, [2009] AC 1391.

A broader test

6.18 In *Meridian Global Funds Management Asia Ltd v Securities Commission*, Lord Hoffmann held that the court should not look solely at the corporate hierarchy but should also consider the purpose of the provision in question. The test should further that purpose:

> Whose act (or knowledge, or state of mind) was *for this purpose* intended to count as the act etc of the company? One finds the answer to the question by applying the usual canons of interpretation, taking into account the language of the rule (if it is a statute) and its content and policy.[11]

6.19 For example, in *Re Supply of Ready Mixed Concrete (No 2), Director General of Fair Trading v Pioneer Concrete (UK) Ltd*, a company was held liable for the acts of employees in contravening a restrictive practices order, even though the board had instructed them not to.[12]

6.20 This broader test recognises that it is sometimes necessary to attribute the acts or thoughts of individuals who were not part of "the directing mind and will" of the corporation. Otherwise directors could insulate the corporation by delegating their functions and claiming to have no knowledge of what was done.[13]

6.21 The court stressed, however, that they were not proposing to extend the general test to include all employees - the test depended on the facts of each particular case.[14]

Attributing knowledge for the purposes of section 18

6.22 So how should knowledge be attributed to further the purpose of section 18 of the 1906 Act? In *PCW Syndicates*, Lord Justice Staughton observed:

> I can see no reason to restrict the knowledge of a company under s18 to what is known at a high level, by the directing mind and will. I would have thought that knowledge held by employees whose business it was to arrange insurance for the company would be relevant, and perhaps also the knowledge of some other employees.[15]

6.23 We think that this is broadly correct and applies to all corporate policyholders. Section 18 must clearly apply to anything known to the directing will and mind of the company. In the case of a large publicly quoted company, this would normally be members of the board. If the board know material circumstances, these should be disclosed. It should be no excuse that the board concealed information from their risk manager.

[11] [1995] 2 AC 500 at 507.

[12] [1995] 1 AC 456.

[13] See further, *Bank of India v Morris* [2005] EWCA Civ 693, [2005] 2 BCLC 328 and *Safeway Stores v Twigger* [2010] EWCA Civ 1472, [2011] Bus LR 1629.

[14] Above at 511.

[15] [1996] 1 WLR, 1136 at 1142, [1996] 1 All ER 774 at 780 g.

6.24 It is also appropriate that knowledge should be attributed to the employees and agents who arrange insurance.

6.25 We think, however, that it is unhelpful to talk about "perhaps" including the knowledge of some other employees.[16] This is an issue on which businesses and insurers need more certainty. We think that the more helpful way of including information known by other employees is to place the persons arranging insurance under a duty to make reasonable enquiries (including questioning other employees). Below we consider the extent to which insurance managers should investigate.

WHAT SHOULD THE RELEVANT PERSON KNOW?

6.26 The next question is what a policyholder ought to know in the ordinary course of business. There are several difficult issues with this test. The first is whether it is limited only to blind eye knowledge – things which the policyholder would have known had it not deliberately avoided acquiring the information. Alternatively, does it extend to a positive duty to make enquiries?

6.27 There is also a debate over whether the test is objective or subjective. Does it extend to information which a risk manager would have discovered in a reasonably well-run company, or only to information which a risk manager would have discovered through reasonable inquiries in the fallible, and sometimes negligent, company which actually sought insurance?

6.28 The current law on these issues is malleable and driven by the facts of individual cases. The various issues are often considered together, which obfuscates the true meaning of section 18(1) of the 1906 Act. Below we examine the cases to draw out the best principles.

Blind eye knowledge or a duty to enquire?

Blind eye knowledge

6.29 It is well accepted that knowledge includes circumstances which a prospective policyholder has "turned a blind eye" to. While the boundaries of wilful blindness are not precise, the courts have consistently interpreted knowledge to include cases where someone has deliberately failed to make an enquiry in case it results in the receipt of unwelcome information.[17] The House of Lords has described blind eye knowledge as arising where a person "deliberately shut his eyes to the obvious because he suspected the truth and did not want to have his suspicion confirmed".[18]

[16] Note that in *Australia & New Zealand Bank v Colonial & Eagle Wharves Ltd* [1960] 2 Lloyd's Rep 241, the chief clerk who oversaw the system for releasing imports to the right person was held not to fall within the class of people whose knowledge could be attributed to the company.

[17] *Roper v Taylor's Garage* [1951] 2 TLR 284.

[18] *Westminster City Council v Croyalgrange Ltd* (1986) 83 Cr App R 155 at 164 by Lord Bridge and see further Ormerod; *Smith and Hogan's Criminal Law*; (2011 13th ed) at paras 5.2.7 and 5.2.8. Scottish criminal law cases on this topic include *Friel v Docherty* 1990 SCCR 351 and *Latta v Herron* (1967) SCCR Supp 18.

6.30 In *ERC Frankona Reinsurance v American National Insurance Company*, the question was whether the insurers, who placed reinsurance with ERC in relation to their interest in a programme called the National Accident Insurance Group knew or should have known that the Chief Operating Officer of the Group had a criminal record.[19]

6.31 On the facts, Mr Justice Andrew Smith found that the American National Insurance Company had actual knowledge of the criminal conviction, but he expressed the view that a lesser test would have sufficed.[20] Even in the absence of actual knowledge, the Company's senior vice president had been told enough about the Chief Operating Officer that any insurer would have made enquiries:

> … unless the insurer was deliberately avoiding acquiring information that he felt that he might prefer not to know. [21]

6.32 This is a helpful formulation of the blind eye knowledge test. It is clearly right that one should look not only at what the relevant people knew but also at information they had deliberately avoided acquiring for fear it might be something they do not want to know because it would confirm their suspicions.

A duty to enquire?

6.33 The question is whether the test goes beyond "blind eye" knowledge to a positive duty on the policyholder to make enquiries. Some cases suggest that it does.[22]

6.34 An example is *The Dora*, where the policyholders insured a yacht without mentioning that the skipper had a criminal record. [23] The yacht was managed by a managing agent. Mr Justice Phillips found that the managing agent had failed to check the skipper's character, even though the normal course of business required him to do so. Therefore, the owners of the yacht had constructive knowledge of this material fact which should have been disclosed. Accordingly, the defendants were entitled to avoid the contract of insurance.

[19] [2005] EWHC 1381 (Comm); [2006] Lloyd's Rep IR 157.

[20] At [117] – [120].

[21] At [199].

[22] See for example *London General Insurance Co Ltd v General Marine Underwriters' Association Ltd* [1920] 3 KB 23. The insurers put the daily notice of marine losses in a drawer without reading it. The list contained information about a ship which they reinsured later that day. The Court of Appeal held that the policyholder should have been aware of the information contained in the notice which it had put in the drawer, and it should have been disclosed: the pressure of business in the underwriting department was no excuse.

[23] *Inversiones Manria SA v Sphere Drake Insurance Co Plc* [1989] 1 Lloyd's Rep 69 at 94-95.

6.35 In Part 5, we discussed the case of *Aiken v Stewart Wrightson Members Agency Ltd*, where managing agents failed to disclose the policyholders' full exposure to asbestosis claims.[24] The case is also authority for the proposition that a policyholder has a duty to make appropriate enquiries. The evidence as to whether the agents had in fact taken steps to find out about their exposure to claims for asbestosis was unclear. The court found, however, that even if they had made enquiries they were not sufficient and the agents were negligent in their disclosure to the reinsurers.

A subjective or objective test?

6.36 If the policyholder has an obligation to make reasonable enquiries, is that to be judged by an objective or subjective test? There has been debate in the textbooks over whether an assessment of what the policyholder should know is subjective, by reference to the way the policyholder actually runs its business, or objective, by reference to the way a reasonable policyholder would run its business.

6.37 The editors of the sixteenth edition of *Arnould's Law of Marine Insurance and Average* considered the constructive knowledge test to be subjective. They commented:

> The test of what 'ought to be known' by the assured is not, therefore, an objective test of what ought to be known by a reasonable, prudent assured carrying on a business of the kind in question, but a test of what ought to be known by the assured in the ordinary course of carrying on his business in the manner in which he carries on that business; the underwriter takes the risk that the business may be run inefficiently unless the circumstances are such that the assured knows or suspects facts material to be disclosed.[25]

The editors explain that:

> To hold otherwise would be tantamount to saying that underwriters only insure those who conduct their business prudently, whereas it is a commonplace that one of the purposes of insurance is to obtain cover against the consequences of negligence in the management of the assured's affairs.[26]

6.38 *Clarke*, however, advocates an objective interpretation:

[24] [1995] 3 All ER 449; [1995] 2 Lloyd's Rep 618. See also Part 5, paras 5.34 to 5.37. This decision was confirmed on appeal although it should be noted that the appeal did not relate to the issue of non-disclosure: [1996] 2 Lloyd's Rep 577.

[25] Passage taken from *Arnould's Law of Marine Insurance and Average*, (1997 16th ed), para 640 quoted at para 16-36 (2008 17th ed).

[26] *Arnould's Law of Marine Insurance and Average* (2008 17th ed) para 16-38 citing *Australia & New Zealand Bank Ltd v Colonial & Eagle Wharves Ltd* [1960] 2 Lloyd's Rep 241 at [252].

> As with defendants charged with the tort of negligence, what can be reasonably expected of people varies according to, not the particular individual person, but the particular *kind* of person in question.[27]

6.39 In the seventeenth and most recent edition of *Arnould's Law of Marine Insurance and Average*, the editors noted recent cases and moved towards a more objective standard:

> There is a subjective element, that the insured is a member of a class (such as in the PCW case a Lloyd's syndicate) but beyond that the question should be judged objectively, by reference to a reasonable, prudent insured in that class.[28]

Negligent corporations

6.40 The case of *Australia & New Zealand Bank Ltd v Colonial & Eagle Wharves Ltd* is used to justify a subjective standard.[29]

6.41 In this case, a bank financed the import of wool. The policyholders were wharfingers, operating a wharf which received and stored the wool. The bank had agreed with the wharfingers that the wool would not be released without their permission. By mistake, the wharfingers released 246 bales of wool to the importers without the bank's authority. When the bank sued the policyholders for breach of contract, the policyholders made a claim under two Lloyd's all-risks policies for the loss.

6.42 The insurers denied liability. They claimed the policy was avoided on the ground that the wharfingers had not disclosed that their operating systems were such that they could release wool without the bank's authority.

6.43 The Court found that none of the board, the managing director or the wharf manager knew that the operating systems could lead to this result. The only person who knew was the chief clerk who oversaw the permission process. Nevertheless, the insurers argued that the board of the wharfingers would have known the material facts if they had made such inquiries as to their system as a reasonably prudent wharfinger company would have made in the ordinary course of business. They therefore claimed that the test under section 18(1) of the 1906 Act had been met.

6.44 The judge rejected this contention. He was not persuaded that there was any duty on a proposing policyholder to carry out a detailed risk assessment of this nature. He commented: [30]

> To impose such an obligation upon the proposer is tantamount to holding that insurers only insure persons who conduct their business

[27] M A Clarke, *The Law of Insurance Contracts*, para 23-8C1.

[28] *Arnould's Law of Marine Insurance and Average* (2008 17th ed) para 16-46.

[29] [1960] 2 Lloyds Rep 241; see *Arnould's Law of Marine Insurance and Average*, (2008 17th ed) at paras 16-25 to 16-27 and 16-38 and Legh-Jones, Birds and Owen, *MacGillivray on Insurance Law*, (11th ed 2008) para 17-013.

> prudently, whereas it is commonplace that one of the purposes of insurance is to cover yourself against your own negligence or the negligence of your servants.

6.45 *MacGillivray* cites this case to support the contention that:

> The assured is deemed to know only what he would be expected to know in the ordinary course of his own business, making allowance for its imperfect organisation, prior to the conclusion of the insurance. Therefore, he is not deemed to be aware of matters which should be known to him in the course of a well run business which he would have found out if he had re-organised his schedule or business system at the time in question. He need not undertake any special enquiry for the benefit of the insurer, although, if he does, the findings, if material, should not be kept back. [31]

6.46 It is important to note, however, that Mr Justice McNair also found on the facts that any reasonable enquiries the board could be expected to make would not have revealed the information the underwriter claimed was material.[32] This may be a better way of addressing the issue: even if those placing insurance had made reasonable enquiries, it is unlikely that the chief clerk would have admitted to his own negligence.

Concealing fraud

6.47 Two recent cases have confirmed that a policyholder is not required to know that it is being defrauded.

6.48 The first is *PCW Syndicates v PCW Reinsurers*, which concerned a reinsurance contract.[33] The insurers, PCW Syndicates, used agents where several individuals were misappropriating premiums. The reinsurers purported to avoid the contract on the ground that this was a material fact which should have been disclosed, as it went to the insurer's assessment of moral hazard.

6.49 The case mainly turned on section 19 of the 1906 Act and is considered in Part 7. However, the Court of Appeal also addressed the issue of knowledge under section 18(1). Although his comments are non-binding, Lord Justice Staughton observed:

> It seems distinctly implausible that an agent would disclose to his principal, whether in the ordinary course of business or otherwise, that he has been defrauding his principal.[34]

[30] *Australia & New Zealand Bank Ltd v Colonial & Eagle Wharves Ltd* [1960] 2 Lloyd's Rep 241 [252].

[31] See Legh-Jones, Birds and Owen, *MacGillivray on Insurance Law*, (11th ed 2008), para 17-013.

[32] [1960] 2 Lloyds Rep 241 at 252.

[33] [1996] 1 WLR 1136, [1996] 1 All ER 774.

[34] Above at 1138C; [780a].

6.50 Later, he commented:

> One has to consider what an honest and competent agent would communicate to the assured in the ordinary course of business… The honest and competent agent would not have any dishonesty to reveal.[35]

6.51 The second case is *Group Josi Re v Walbook Insurance Co Ltd.*[36] Group Josi, a Belgian reinsurance company, alleged non-disclosure against the defendant insurance companies and their agent. Group Josi claimed that the defendants had failed to disclose fraudulent conduct by the chairman, deputy chairman and managing director of the agent who were taking an overriding commission from the reinsurers for their own benefit instead of crediting to the insurers.

6.52 Following the reasoning employed in *PCW*, Lord Justice Saville held that section 18 of the 1906 Act does not require disclosure of information that an agent fraudulently withholds from its principal:

> The section itself distinguishes between the knowledge of the assured and knowledge which the assured is deemed to have. The latter type of knowledge is limited to circumstances which, in the ordinary course of business, ought to be known by the assured. To my mind, the proposition that in the present case the reinsured companies ought in the ordinary course of business to have known that they were being defrauded simply offends common sense. In the ordinary course of business those being defrauded do not know of that fact. If they did, they would not be defrauded.[37]

6.53 The case demonstrates the importance of separating the attribution question from the question of constructive knowledge. If a person's knowledge is attributed to a corporation, then the corporation is deemed to know any information which that person may fraudulently or negligently withhold. If, however, the corporation is only required to make enquiries from them, the corporation does not have constructive knowledge of information which has been deliberately withheld from it.

VIEWS ON THE KNOWLEDGE TEST

6.54 The issue of what a policyholder "ought to know" is a major concern to large companies. As John Hurrell of Airmic (the risk managers' association) put it:

[35] Above at 1138C; [781e].

[36] [1996] 1 All ER 791.

[37] Above at 807j – 808a; see also 810b.

> The current law was drafted before the existence of large, complex, multinational organisations and it fails to make clear what the risk manager has to do. In a large company it is simply not possible for the risk manager to anticipate every piece of information that an underwriter might deem material.[38]

6.55 He pointed out that many members had included terms in their contracts to define whose knowledge was relevant.

> For example, one member has it as "knowledge residing in the insurance department," not in the heads of every employee throughout the company world wide. Other members have defined and agreed prior to inception the range of remedies open to the insurer, depending on the circumstances.[39]

6.56 On the other hand, "helpful though these initiatives might be, they simply paper over the cracks in our outdated insurance law".[40]

Responses to our 2007 proposal

6.57 In our first Consultation Paper, we proposed to re-enact section 18(1) in slightly simpler terms. We said simply that the duty of disclosure should be limited to facts which the business policyholder knew or ought to have known.[41]

6.58 At least 34 respondents agreed with our proposal, mostly without comment, though one respondent commented that they had not appreciated the full extent of the burden the law imposes on a purchaser of insurance. At least five respondents disagreed with any change, and wished to retain the current wording of section 18. These included the Lloyd's Market Association, the ABI, Global Life Reinsurance, Fortis, and the British Maritime Law Association.

6.59 A few respondents, however, said that they did not understand how the "knew or ought to know test" operated and that there was a need for further clarification on the issue. We have listened carefully to these arguments.

6.60 One respondent highlighted the difficulty in determining whose knowledge should be attributed to a company:

[38] Jonathan Swift, Comment – insurance law reform: Reform can't wait; *Post Magazine* [14 April 2010].

[39] Above.

[40] Above.

[41] Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured (2007) LCCP 182/SLCDP 134, para 5.44. The main reason for the change of words was to allow remedies to distinguish between fraudulent and negligent conduct. We did not wish people to be deemed to know things they did not know because of the slightly clumsy wording of section 18(1) of the 1906 Act.

> In a company composed of three equal directors, who will be considered the controlling mind of the company for insurance purposes? Where one of those directors is solely responsible for obtaining insurance, will it be reasonable for her to rely on unverified information provided by the other two? Will that remain reasonable where a clear inference can be drawn against one of the directors that they alone intended to mislead the insurer?

6.61 The City of London Law Society also asked about the attribution of knowledge:

> For example, in relation to an insurance taken out by a company, would reasonableness be judged by reference to the company's systems, or of employee A who was responsible for operating them, or of employee B who failed to pick up the information in question or picked it up but failed to report it to A? It would be helpful if the position could be clarified.

6.62 Jonathan Hirst QC argued that the policyholder's obligations to make reasonable enquiries should be made explicit:

> The issue of deemed knowledge is a difficult one. Certainly, the current section 18(1) of the 1906 Act can be harsh. However, I am concerned that to simply abolish it sends out the wrong message, especially in large organisations where there will be ample room for argument about whose knowledge should be attributed to the organisation. I would suggest that, as part of your proposal that question should be whether the insured who is unaware of a material fact, and therefore did not disclose it, was reasonable or negligent, it should be made explicit that the insured should make reasonable enquiries.

6.63 BILA emphasised that issues of knowledge raised particularly difficult policy issues, and that their members' views were split on this issue. It said that some members thought that:

> The insured's knowledge of facts should be judged by the reasonableness of his conduct and that, in particular, the insured should not be entitled to disclaim knowledge of facts due to deficiencies in its organisation or the incompetence of its employees. Other members believe that insurers should continue to assume risk that the insured's business is badly run, and should not be entitled to assume (and effectively extract a representation to that effect) that the insured's business is well managed.

6.64 The Chamber of British Shipping's response advocated more rigorous enquiries on both sides:

> It is accepted that the potential insured must be both candid and careful but, equally, the insurer must clearly indicate the scope of information required and extent to which further investigations might be necessary. This perhaps argues for better pre-information with more rigorous inquiries on both sides.

6.65 Derrick Cole and Geoffrey Lloyd agreed. They felt that there should be greater obligations on both sides to ensure there was adequate disclosure. They felt that a commercial risk survey "was not an unnecessary luxury" but "a sound investment" when it came to making a disclosure.

6.66 We have been persuaded that it is not enough for the legislation merely to refer to information which a company knows or ought to know. For large corporate policyholders the issue is of major practical concern: they need to know who needs to make enquiries of whom. At present, the law is unhelpfully confused on this issue.

6.67 We think that the law needs to do more to encourage better exchange of pre-contract information on both sides. In particular, the policyholder has a duty to make reasonable enquiries, and we think it would be helpful to make this explicit on the face of the statute. This is part of a reciprocal exchange. In Part 5, we discussed the insurer's duty to make enquiries.

The Airmic guide

6.68 In 2011, Airmic published its guide, *Disclosure of Material Facts and Information in Business Insurance*. The guide attempts to give guidance to buyers about what information should be disclosed and what procedures a company should go through before preparing its disclosure document. It notes that:

> For many large, complex international companies, the disclosure obligations of the MIA have become very onerous. Identification, collection and collation of all material information related to the risk can be a very difficult task and involves multiple sources of information.[42]

6.69 The guide notes that:

> Disclosure procedures should be proportionate to the size, nature and complexity of the business. For many companies, the disclosure procedures will be simple and will merely involve completion of a proposal form by an authorised person. However, for large complex businesses, formal disclosure procedures are likely to be required.[43]

6.70 Airmic suggests that the company should start by allocating roles and responsibilities. These might include

(1) a knowledgeable person (or persons), who holds or has access to material information;

(2) a responsible person, who has the task of compiling the material information; and

(3) an authorised person to sign-off the information as full and accurate and seek assurance that the disclosure procedures are suitable and sufficient.

[42] Part 1, Introduction – *current market practice* at p 5.

[43] Part 2, Disclosure procedures – *design of disclosure procedures* at p 6.

6.71 The guide emphasises that it is important to document roles and responsibilities, and if possible agree them with the insurer.

6.72 Law reform will never be a substitute for detailed guidance of this type, but we think that the law should establish a clear framework, which can be augmented by more detailed industry guidance and agreements.

PROPOSALS FOR REFORMING HOW KNOWLEDGE IS ATTRIBUTED UNDER SECTION 18

6.73 For large companies and other corporations, the issue of what the policyholder knows or ought to know has major practical implications. We think it would be helpful to provide greater clarity on this issue. We therefore propose a re-statement of the law, which will draw on the best principles in the current case law to clarify both whose knowledge is relevant, and what enquiries need to be made.

6.74 We think that the first question of whose knowledge can be attributed to the corporation for the purposes of section 18 of the 1906 Act must include both the directing mind and will of the corporation and the staff who placed the insurance in question. This follows the statement of Lord Justice Staughton in *PCW Syndicates* that the attribution of knowledge is not restricted to the directing mind and will but also includes knowledge held by employees whose business it was to arrange insurance for the company.[44] All material circumstances known to the directors or partners and to the insurance buyer or buying team should be disclosed.

6.75 For these purposes, we think that knowledge includes not only actual knowledge but also "blind eye" knowledge, that is any information which the directors/partners and insurance buyer deliberately avoided acquiring because they preferred not to know.

6.76 In addition, we think that a corporation should be under a duty to make reasonable enquiries before placing insurance. We agree with Airmic that enquires should be proportionate to the type of insurance and to the size, nature and complexity of the business. For many companies, enquiries will be simple and merely involve answering the questions on the proposal form. For larger complex businesses, more will be required. Although the question of whether the enquiries are reasonable must depend on nature, size and complexity of the business, we think it must involve an objective standard. We think it is appropriate for the legislation to set out a general test which can then be clarified by industry guidance and by agreements between businesses and insurers.

[44] [1996] 1 WLR 1136 at 1142.

6.77 The insurer should have a remedy against a policyholder who fails to disclose information which would have been discovered by those enquiries. On the other hand, there would be no requirement to disclose information which would not be revealed by reasonable enquiries, such as the fact that some staff or agents are defrauding the company. The test should accept that not all companies are perfectly run. As the judge put it in *Australia & New Zealand Bank Ltd v Colonial & Eagle Wharves Ltd,*[45] insurance should not only be available to those who "conduct their business prudently", as "one of the purposes of insurance is to cover yourself against your own negligence or the negligence of your servants".

6.78 **Do consultees agree that**:

(1) For the purposes of deciding what a business policyholder should disclose to an insurer before concluding an insurance contract, the issue of what constitutes knowledge should be clarified in legislation?

(2) Where a business policyholder is a corporate entity, "knowledge" should include information known to:

(a) The directing mind and will of the organisation; and

(b) The persons who arranged the insurance on behalf of the organisation?

(3) For these purposes "knowledge" should mean:

(a) Actual knowledge; and

(b) "Blind eye" knowledge?

(4) A business policyholder should also be under a duty to disclose information that would have been discovered by reasonable enquiries, which are proportionate to the type of insurance and to the size, nature and complexity of the business?

THE POLICYHOLDER'S KNOWLEDGE AND SECTION 20

6.79 So far, we have only considered the policyholder's knowledge in relation to the duty of disclosure under section 18 of the Marine Insurance Act 1906. Section 20 of that Act sets out an additional duty on the policyholder, namely not to make a misrepresentation.

[45] [1960] 2 Lloyd's Rep 241; see *Arnould's Law of Marine Insurance and Average* (17th ed 2008), para 16-38; Legh-Jones, Birds and Owen, *MacGillivray on Insurance Law*, (11th ed 2008), para 17-013.

The current law

6.80 Section 20 deals with the issue of knowledge in a different way. Under section 20(3), a representation may either be "a matter of fact", or "a matter of expectation or belief". If it is a matter of fact, it must be true.[46] If it is a matter of expectation or belief, it must be "made in good faith".[47]

For matters of expectation or belief, good faith is sufficient

6.81 The leading case on this issue is a consumer decision, *Economides v Commercial Union Assurance Co Plc*.[48] The policyholder, a 21 year old man, undervalued the contents of his flat after his parents moved in with him. Following a suggestion from his father that the additional belongings were worth a few thousand pounds, he increased the household contents valuation to only £16,000. The flat was burgled. Most of the items stolen belonged to his parents and their replacement cost was £30,970.

6.82 The court found that the insurers did not have a right to avoid the policy. Instead, an average should apply. As the policyholder's statements were a matter of opinion rather than fact, it was sufficient that they were held in good faith. It was not necessary that they should be based on reasonable grounds.[49] Lord Justice Peter Gibson put the point as follows:

> Once statute deems an honest representation as a matter of belief to be true, I cannot see that there is scope for inquiry as to whether there were objectively reasonable grounds for that belief. Of course the absence of reasonable grounds for that belief might point to the absence of good faith for that belief. But in a case such as the present where the bad faith of the plaintiff is not alleged, I can see no basis for implication of a representation of reasonable grounds for belief.[50]

6.83 Subsequent commercial cases have followed this approach. In *"The Game Boy"*,[51] the policyholder had expressed the opinion that the vessel which he had purchased as a floating casino was worth US$1.8 million. In fact, the vessel was worth something between US$100-150,000 for scrap. Mr Justice Simon took the above statement by Lord Justice Peter Gibson to be an accurate expression of the law. He concluded that the policyholder could not have genuinely believed in the truth of his stated opinion. The evidence showed that he had even produced a variety of fake documents to support it.

[46] See s 20(4), set out in Part 2, para 2.43.

[47] See s 20(5), set out in Part 2, para 2.44.

[48] [1998] QB 587.

[49] Above by Simon Brown and Peter Gibson LJJ. Sir Iain Glidewell preferred to leave the matter open. See H Bennett "Statements of Facts and Statements of Belief" (1998) 61 MLR 886; J Cartwright, *Misrepresentation, Mistake and Non Disclosure* (2nd ed 2007) para 2.14.

[50] As above, at 606.

[51] *Eagle Star Insurance Co Ltd v Games Video Co (GVC) SA ("The Game Boy")* [2004] EWHC 15; [2004] Lloyd's Rep IR 867.

6.84 In *Rendall v Combined Insurance Co of America*,[52] an employer insured the lives of its employees while they travelled on business, estimating 160,000 days travel. The insurer sought to avoid the contract on the basis that this had been a misrepresentation. Mr Justice Creswell held that this had been a statement of expectation, and that such an expectation need not be based on reasonable grounds. In any event, the policyholder did have reasonable grounds for making the statement, having taken into account relevant sources of information.

When is a statement one of fact, and when of expectation or belief?

6.85 The distinction between a representation of fact and one of belief is a matter of construction. In *Economides,* Lord Justice Simon Brown accepted that something which at first glance may appear to be a statement of belief may actually be a statement of fact.[53] Moreover, a statement of fact cannot be disguised as a statement of belief by using words such as "I think" or "in my opinion".[54] In *Sirius International Insurance Corp v Oriental Assurance Corp*,[55] for instance, Mr Justice Longmore held that a statement about the existence of fire hydrants on the premises was a representation of fact, even though it commenced with "we had been informed".

6.86 The courts are heavily influenced by whether the matter is one which the policyholder knew about or should have known about. If the representation was one which the policyholder should have known about, the court is likely to hold that the statement must be true. If it is outside the matters which the policyholder could be expected to know about, it is probably a matter of expectation or belief.

6.87 For example, in *Bowden v Vaughan*[56] a broker who insured goods on a ship represented to the insurer that the ship would "sail in a few days". The ship did not sail for a month. The court held that as the owner of the goods had no control over the ship, this statement must be taken as a matter of expectation. Similar conclusions were reached in *Hubbard v Glover*[57] and *Brine v Featherstone,*[58] which both concerned representations about the position of a ship. As the brokers who made those representations could not have known the precise position of the ships,[59] these were deemed to be statements of expectation.

6.88 *Arnould* comments on this line of cases as follows:

[52] [2005] EWHC 678 (Comm).

[53] [1998] QB 587, at 598.

[54] *Ionides v Pacific Fire and Marine Insurance Co* (1871) LR 6 QB 674.

[55] [1999] Lloyd's Rep IR 343.

[56] (1809) 10 East 415.

[57] (1812) 3 Camp 313.

[58] (1813) Taunt 869.

[59] This is a consequence of the limited means of communication available at the time.

> [T]here is an emphasis on the insurer being able to distinguish between matters that the policyholder might be expected to know about and those which it might not, with the onus being on the insurer to make further enquiries into the latter category.[60]

6.89 Take a case, for example, where a company is asked whether a particular employee has a non-spent criminal conviction. The company answers in the negative. If the court considers that the company knew or should have known about the conviction, then this would almost certainly be considered an issue of fact. As the answer was not true, the company will have breached its duty under section 20 of the 1906 Act and the contract can be avoided.

6.90 It may be, however, that the company followed reasonable procedures and failed to find out about the conviction. Suppose, for example, that the employee lied and, as the conviction occurred abroad, it did not appear on the criminal record check the company carried out. In these circumstances, the court may well find that the statement that the employee did not have a criminal record was no more than a statement of belief. In this case it is sufficient for the company to have acted in good faith.

Proposals for reform

6.91 We think the different treatments of knowledge under sections 18 and 20 of the 1906 Act are overly complex. In practice, the dividing line between a non-disclosure and a misrepresentation can be narrow. If, for example, an insurer asks "is there any other information regarding the risk which would influence our decision?" and the policyholder answers "no", it is possible to argue that any non-disclosure is also a misrepresentation. It would be unfortunate if the standard of knowledge required differed according to whether the insurer did or did not ask a general question of this type.

6.92 We think that the law would be clearer and simpler if the same standard of knowledge applied to both section 18 and section 20.

6.93 We seek views on whether section 20 should be amended to distinguish not between "matters of fact" and "matters of expectation or belief" but between matters which the policyholder "knew or ought to know" about (as defined in paragraph 6.75) and other matters. We think the courts already decide cases in this way, and that it would be simpler to recognise this.

6.94 We propose that where the matter is one which the policyholder knew or ought to know about (as previously defined), then the representation must be true. If it is not true, the insurer should have an appropriate remedy. If, however, the matter is not one the policyholder had any reason to know about, then it would be sufficient if the representation was made in good faith.

[60] *Arnould's Law of Marine Insurance and Average*, (17th ed 2008), para 17-45.

6.95 **Do consultees agree that**:

(1) Rather than distinguish between "matters of fact" and "matters of expectation or belief", section 20 of the 1906 Act should be amended to distinguish between matters which the policyholder knew or ought to know about (as previously defined) and other matters?

(2) Where the representation is one which the policyholder knew or ought to know about, it must be true?

(3) Where the representation is not one which the policyholder knew or ought to know about, it must be made in good faith?

PART 7
THE BROKER'S KNOWLEDGE

INTRODUCTION

7.1 The duty to disclose is not confined to circumstances which the policyholder knows or ought to know. Under section 19 of the Marine Insurance Act 1906 (the 1906 Act), where the policyholder uses a broker or other agent to effect insurance, the agent is also required to disclose information to the insurer.

7.2 Section 19 is a difficult provision to understand. On first sight it appears to place a duty on the broker to the insurer, but this may be a misleading way of characterising the section. Section 19 does not give the insurer a cause of action against the broker.[1] Instead, the only remedy for breach of the section by the broker is that the insurer may avoid its contract with the policyholder. The effect of the section, therefore, is to extend the policyholder's duty to the insurer, not only to disclose information which the policyholder knows or ought to know, but also to disclose additional circumstances which are known only to the broker.

7.3 The law on section 19 of the 1906 Act is confused, with several contrary judicial statements about what it covers. If taken literally the section appears to be wide: it could extend to information which the broker acquired from another client, and which the policyholder has no reason to know. This has the potential to lead to conflicts of interest.

7.4 In practice, despite its apparent width, section 19 is invoked relatively rarely. We have found only 20 reported cases in the last 100 years. Furthermore, when faced with specific facts, the courts have given it a restricted interpretation.

7.5 In Part 6, we argued that there was a need to clarify what information a corporate policyholder "knows" or "ought to know". Similar arguments apply here. We think that there is also a need to clarify what the policyholder's agent "knows" or "ought to know" in this context.

7.6 As we argue below, brokers may have acted for clients for many years, and acquired considerable knowledge of the client's business. It is therefore right that the duty of disclosure should include not only information known by the employee placing the insurance, but also any information received or held by the agent in the course of acting for the policyholder. This should apply to all brokers in the chain. On the other hand, we think it would be helpful to clarify that this does not include information given to the broker by other clients.

THE CURRENT LAW: SECTION 19 OF THE MARINE INSURANCE ACT 1906

7.7 Section 19 of the 1906 Act applies where the policyholder uses a broker to effect insurance. It reads as follows:

[1] *HIH Casualty and General Insurance Co Ltd v Chase Manhattan Bank* [2003] Lloyd's Rep IR 230.

> Subject to the provisions of the preceding section as to circumstances which need not be disclosed, where an insurance is effected for the assured by an agent, the agent must disclose to the insurer—
>
> > (a) Every material circumstance which is known to himself, and an agent to insure is deemed to know every circumstance which in the ordinary course of business ought to be known by, or to have been communicated to, him; and
> >
> > (b) Every material circumstance which the assured is bound to disclose, unless it come to his knowledge too late to communicate it to the agent.

7.8 The opening words of the section clarify that these provisions are subject to the exceptions to the duty of disclosure set out in section 18(3). Thus, for example, the broker need not disclose circumstances which diminish the risk or where the insurer has waived the information.

7.9 Section 19 of the 1906 Act is based on two nineteenth century cases arising out of the reinsurance of a steamship, the *State of Florida*.[2] In 1884, Blackburn Low & Co insured the *State of Florida*, sailing from New York to Glasgow. Blackburn Low then placed two reinsurance contracts.

7.10 In the first case*, Blackburn Low v Haslam*,[3] the insurers had used Glasgow agents who contacted London agents and placed the insurance through a Lloyd's broker. After the ship was lost, it became known that Mr Murison, a partner in the Glasgow firm, had spoken to the ship owners. During the conversation, the owners' manager mentioned that there had been reports that the *State of Florida* had been lost and that some of its crew had been seen on another vessel. However, these rumours were not known to the insurer. The Court of Appeal found that the reinsurers could avoid the policy as the Glasgow agent had not told the reinsurers this important information.

7.11 The second reinsurance was placed through different agents. In *Blackburn Low v Vigors*,[4] the House of Lords found that this second policy was unaffected. The knowledge of the Glasgow agents could not be imputed to the insurers in these circumstances.

7.12 Section 19 codifies this principle and has been taken to apply to non-marine as well as marine insurance.[5]

[2] *Blackburn Low & Co v Haslam* (1888) LR 21 QBD 144 and *Blackburn Low & Co v Vigors* (1887) LR 12 App Cas 531.

[3] (1888) LR 21 QBD 144.

[4] (1887) LR 12 App Cas 531.

[5] See *PCW Syndicates v PCW Reinsurers* [1996] 1 WLR 1136.

THE NATURE OF THE DUTY

7.13 If the agent fails to disclose, section 19 does not give the insurer any rights against the agent. Instead, the consequences of the agent's failure to disclose are visited on the policyholder. The insurer may avoid the policy against the policyholder, refusing all claims.

7.14 Section 19 is therefore best seen as an extension of the policyholder's duty to disclose. The policyholder must not only disclose the information which it knows or ought to know, but must also ensure the disclosure of any information which the agent knows or ought to know. If not, the policyholder may suffer harsh consequences.

7.15 There are two parts to section 19:

(1) Section 19(b) simply requires the agent to disclose every material circumstance which the policyholder is bound to disclose. This does not appear to add anything to the duty set out in section 18. If the policyholder is bound to disclose information, but that information is not disclosed (either directly or through an agent) then the insurer may avoid the contract under section 18. Section 19(b) simply repeats this in a different form. The section does no harm, but appears otiose. We do not think that it is needed.

(2) Section 19(a) is more problematic. It extends the policyholder's disclosure requirement beyond information which the policyholder knows or ought to know, to information which only the agent has any reason to know. This leads to difficult questions. First, to which agents does the duty extend, and, secondly, what information is included?

7.16 If taken at face value, section 19(a) could extend widely, to any information received by the broker in any capacity. As the broker market consolidates, brokers may act for hundreds if not thousands of clients, receiving sensitive market information over vast numbers of claims throughout the industry. Is a broker expected to disclose confidential claims information relating to other clients? The market's view would appear to be that it is not.

7.17 As we discuss below, the courts have restricted the application of section 19(a) to cases in which the broker received or held the information in its capacity as agent of the policyholder. Below we look in more detail at how section 19(a) has been interpreted, and propose to limit its scope in line with the current case law.

A MORE DETAILED LOOK AT SECTION 19(a)

Is the section needed at all?

7.18 The main use for section 19 of the 1906 Act appears to be within Lloyd's of London, where Lloyds syndicates delegate their affairs to a managing agent. This point is made in both *Group Josi* and *PCW Syndicates*.[6]

7.19 *Arnould's Law of Marine Insurance and Average* summarises this view:

[6] *Group Josi Re Co SA v Walbrook Insurance Co Ltd* [1996] 1 Lloyd's Rep 345; *PCW Syndicates v PCW Reinsurers* [1996] 1 WLR 1136.

> The communication rule in section 19(a) is particularly important in cases where the assured delegates his affairs in such a way as to mean he neither knows about, nor looks to be informed about the risk; s 18 probably cannot be applied for example to the reinsurance of a Lloyd's syndicate, whose members are not kept informed about business written on their behalf; but their underwriting agents will in the ordinary course both know the material circumstances of the risk and be responsible for arranging reinsurance; in their capacity as agents to insure, or as intermediate agents instructing brokers to place reinsurance, they must disclose to the insurers their knowledge acquired and held in their capacity as the assured's agent or communicate it down the line to the brokers. Section 19(a) (but not it would seem s.18) provides the route to protect the insurer in such cases if the relevant information is not supplied to the broker, or the broker having received such information fails to disclose it.[7]

7.20 In Part 6, we proposed that for the purposes of section 18 of the 1906 Act, knowledge should include circumstances known to the persons who arranged the insurance on behalf of the organisation (or which that person should have discovered on reasonable enquiry). The main purpose of section 19 is to extend the same knowledge requirements not only to employees who place insurance, but also to agents who place insurance.

To which agents does section 19 apply?

7.21 Section 19 is titled "disclosure by agent effecting insurance". Section 19(a) then refers to "an agent to insure". In 1995, the Court of Appeal in *PCW Syndicates v PCW Reinsurers*,[8] held that only the final placing broker fell within section 19:

> It seems to me, both from a reading of the words used in Section 19, and from an examination of the authorities upon which that Section was based, that the "agent to insure" only encompasses those who actually deal with the insurers concerned and make the contract in question.[9]

7.22 This decision has been criticised. At first sight, it does not seem consistent with the *Haslam* case, where the information was known only to the Glasgow agents, who asked other brokers to place the re-insurance. Lord Justice Saville explained *Haslam* on the basis that the placing brokers are deemed to know every circumstance which in the ordinary course of business ought to be communicated to them. Thus the Glasgow agents should have passed the rumours about the ship "down the line to the brokers who actually effected the cover". The placing brokers were deemed to know what the Glasgow agents knew.

[7] *Arnoulds Law of Marine Insurance and Average* (2008 17th ed) p 636, para 16-58.

[8] [1996] 1 WLR 1136.

[9] Above at 1149H.

7.23 In *ERC Frankona Reinsurance v American National Insurance* Mr Justice Andrew Smith thought that there were objections to the reasoning in *PCW*, but said that he was bound by the Court of Appeal's decision.[10] Two further High Court cases support the view that section 19 applies to intermediate agents. In *GMA v Unistorebrand International Insurance*, Mr Justice Rix assumed that the knowledge of an intermediate agent had to be disclosed under section 19.[11] In *Baker v Lombard*, Mr Justice Coleman believed that the majority of the Court of Appeal in *Group Josi* had held that section 19 required an intermediate agent to supply an agent to insure, whom they had instructed, with all material facts known to them.[12]

7.24 In most cases, this debate makes little practical difference. Section 19 states that the final placing agent must not only disclose every material circumstance "known to himself", but also every material circumstance which ought "to have been communicated to him". This means that the insurance may be avoided not only if the placing agent fails to disclose information which it knows, but also if an intermediate agent has failed to pass information up the chain.

7.25 In some circumstances, however, the issue of what should be communicated may depend on the arrangements between the different agents in the chain. Some intermediate agents may not be in the UK, and may be subject to different regulatory regimes about what information should be communicated to whom. Some agents may have made express agreements about what should be communicated to whom. These factors add an unwarranted level of complexity to the law.

7.26 The purpose of section 19 is to extend the duty to disclose to information known not also to employees of the policyholder but also to the agents the policyholder uses to place insurance. Below we argue that this point would emerge more clearly if the section was re-written to include all agents, not simply "agents to insure".[13]

What information is included?

7.27 At first sight, section 19(a) suggests that an agent should tell the insurer about information it has received in any capacity, if that information would influence a prudent insurer in fixing the premium or deciding whether to take the risk.

7.28 There are various observations in the case law which suggest that the section does indeed require an agent to disclose information, regardless of the capacity in which it was received. Lord Justice Hoffmann has made two non-binding comments to this effect. The first was in *El Ajou v Dollar Land Holdings Plc*, a company law case decided in 1993:

[10] [2005] EWHC 1381 (Comm) at 1419; [2006] Lloyd's Rep IR 157.

[11] [1995] LRLR 333.

[12] *Baker v Lombard Continental Insurance Plc* (unreported) 24 January 1997; *Group Josi Re v Walbrook Ins Co Ltd* [1996] 1 Lloyd's Rep 345.

[13] At para 7.72 and following.

> First, there are cases in which an agent is authorised to enter into a transaction in which his own knowledge is material. So for example, an insurance policy may be avoided on account of the broker's failure to disclose material facts within his knowledge, even though he did not obtain that knowledge in his capacity as agent for the insured. [14]

7.29 This was followed in 1994 by *Societe Anonyme d'Intermediaries Luxembourgeois (SAIL) v Farex Gie*:

> In particular, the agent's duty to disclose material circumstances known to him in any capacity, coupled with the generous rules which exist for the attribution of the knowledge of many individuals to a corporate agent, may entitle an insurer to repudiate in circumstances which are far from any ordinary understanding of lack of good faith.[15]

7.30 However, in *PCW Syndicates v PCW Reinsurers*, Lord Justice Staughton found that the duty was restricted to information received as agent for the policyholder:

> I do not find in the authorities any decision that an agent to insure is required by section 19 to disclose information which he has received otherwise than in the character of agent for the assured.[16]

No other judge in the case expressed a view on this point.

7.31 Below we look in more detail at two cases where the courts have restricted the application of section 19 of the 1906 Act.

SAIL v Farex Gie

7.32 In *SAIL v Farex Gie*, the policyholder's brokers had been engaged by an insurer to effect reinsurance but were also employed by the reinsurer to arrange a retrocession. One of the retrocessionaires[17] subsequently repudiated that contract, on the ground that the broker knew that the employee who had signed the retrocession slip had no authority to do so. The reinsurers, in turn, sought to avoid their contract with the insurers, in part on the ground that the broker should have disclosed this under section 19 when approaching them for reinsurance.[18]

7.33 In considering the case, the judges made comments suggesting that section 19 may extend to information held in any capacity. For example, Lord Justice Hoffmann repeated the view that the agent's duty was "to disclose material circumstances known to him in any capacity".[19] Lord Justice Saville also remarked that:

[14] [1994] BCC 143 at 156.

[15] *Societe Anonyme d'Intermediaries Luxembourgeois (SAIL) v Farex G*ie [1994] CLC 1094 at 1111.

[16] [1996] 1 WLR 1136 at 1147.

[17] A retrocessionaire is a reinsurer of a reinsurer.

[18] NB: the retrocessionaires had initially been approached to provide the reinsurance cover but had refused, offering only a proportion of any retrocession.

[19] [1994] CLC 1094 at 1111.

> … the duty on the agent is not confined to knowledge acquired from the assured but extends to knowledge otherwise acquired.[20]

7.34 When it came to the decision, however, the court held that section 19 did not apply. This was because, among other reasons, the knowledge was held in their capacity as retrocession brokers acting for the reinsurer, rather than for the original insurer who instructed them to obtain reinsurance. Lord Justice Hoffmann said that it would be going further than any other court had ever done, to impose an obligation to disclose matters relevant only to the interests of the reinsurer under a different contract to which the policyholder is not a party. Lord Justice Dillon added that section 19 could not be used to require the disclosure of information held under a contract of agency with another party, about which the original principal had no duty or right to inquire.[21]

7.35 *SAIL* was a very unusual case with the legal discussion based upon a set of almost hypothetical facts in the context of international litigation. The case does little to clarify the full scope of section 19. It appears, however, that the courts are extremely reluctant to allow an insurer to avoid an insurance contract against an innocent policyholder on the ground of something which the policyholder did not know, and had no reason to know, but which the broker knew in an entirely different capacity.

Group Josi

7.36 Another limit on the scope of section 19 was established in *Group Josi Re v Walbrook Insurance Co Ltd.*[22] Group Josi claimed to be entitled to avoid the contract of reinsurance, on the ground that the agents failed to disclose that they were defrauding their own clients by taking commissions for their own benefit.

7.37 The Court of Appeal found that section 19 did not require the agent to mention that it was defrauding its own client. This would undermine the so-called *Hampshire Land* principle,[23] by which the agent's knowledge that it is committing a fraud on its principal is not attributed to the principal. The law does not attribute knowledge of a deception to the person who is being deceived.

Conclusion

7.38 The best reading of the current law appears to be that section 19 of the 1906 Act has a limited application. It only applies to information which is received or held by agents in their capacity as agents for the policyholder. We return to this point below.

[20] Above at 1120.

[21] Above at 1102.

[22] [1996] 1 All ER 791.

[23] *Re Hampshire Land Co* [1896] 2 Ch 743.

THE 2007 PROPOSALS AND RESPONSES

7.39 In the 2007 Consultation Paper, we proposed to abolish section 19 of the 1906 Act in consumer insurance. This has now been enacted in the Consumer Insurance (Disclosure and Representations) Act 2012.[24]

7.40 For business insurance we proposed to re-characterise section 19 as imposing a duty on brokers to insurers. Thus, if a broker failed to disclose the requisite information, this would not give the insurer the right to avoid the policy against the policyholder. Instead the insurer would have a direct right to claim damages against the broker.[25]

Consultees' responses

7.41 There was substantial opposition to the proposal to grant insurers a right of damages against brokers. In all, 50 consultees responded to this proposal of which 20 agreed, 24 disagreed, and 6 made comments without agreeing or disagreeing. Many thought that, where the intermediary was the agent of the policyholder, the insurer should continue to be entitled to avoid the policy.

7.42 The London Market Association disagreed in the following terms:

> This proposal is likely to reduce the level of disclosure. We believe that the status quo should be preserved in order to maintain the current balance of power between brokers and insurers, and that all material facts known to the insured, and their agent, ought to be disclosed to the underwriter.
>
> In any event, where this occurs, the insured may be able to sue his agent, the broker, for damages; namely, his loss.

7.43 It was argued that the insured had chosen and employed the broker, so should be held responsible for the broker's faults. Dewey & Le Boeuf commented:

> D&L considers that if the broker acts for the insured than the insured has to live with the consequences of the broker's errors and that the remedy of avoidance should be retained for section 19(a).

7.44 The Commercial Court Users Committee took the same view:

> Section 19(a) reflects a truism of the law that the insured's agent to insure should bear the duty of disclosure, and that the failure to observe that duty will allow the insurer to exercise appropriate remedy/ies and the insured to have recourse against their professional agent.

7.45 RSA argued that it was also impractical for the insurer to sue the broker:

[24] 2012 c 6, s 11.

[25] Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured (2007) LCCP 182/SLCDP 134, para 10.73.

> A dispute with the broker would boil down to evidential issues of what the broker was and was not told by the insured, or what the broker knew. Again, it is our view that the insured is in a better position to prove this than the insurer …. If the LC's proposal were enacted, it would fall on the insurer to join the insured to the proceedings and/or also to have the burden of obtaining evidence/disclosure of documents from the insured.

7.46 We accept that recasting section 19 of the 1906 Act as a duty on the broker to the insurer would be a radical reform, changing the underlying principles of agency law. Given the strong opposition to the proposal, we are not proceeding with it.

Does section 19 give the policyholder a right to damages?

7.47 Several consultees suggested that section 19 should give the policyholder the right to claim damages against the broker.

7.48 Under the current law, an agent owes his principal a duty to exercise reasonable care and skill in fulfilling his duties.[26] This obligation arises in contract, tort/delict, or both. Brokers also owe fiduciary duties to their policyholder as well as a particular duty to protect the policyholder from litigation.[27] Breach of the section 19 duty may be a breach of these various obligations and if the policyholder succeeds, then the broker must put it in the position in which it would have been had the policy not been avoided.[28]

7.49 It does not follow, however, that every breach of section 19 of the 1906 Act will necessarily give the policyholder a right to damages against the broker. The American Judge Duer in a comment approved of in *Arnould's Law of Marine Insurance and Average* stated:

> [The agent] is bound to possess such a knowledge of the law as is essential to the proper discharge of his trust, it by no means follows that every mistake that he may commit, can be considered as an error of ignorance and negligence, that will render him personally liable…. The mistake of the agent, where the practice is unsettled, or the law uncertain, affords no evidence of that want of reasonable skill and ordinary diligence for which he alone is responsible.[29]

7.50 Furthermore, in some cases, the broker may not be the one at fault. The policyholder may have instructed the broker not to disclose information, which would mean that the policyholder was in breach of both sections 18 and 19 of the 1906 Act.

[26] *HIH Casualty and General Insurance Co Ltd v Chase Manhattan Bank* [2003] Lloyd's Rep IR 230. For Scots law, see *SME Reissue* "Agency and Mandate", para 87. This topic is explored in greater depth in *Colinvaux & Merkin's Insurance Contract Law* at p10774/3 onwards.

[27] See *Arnould's Law of Marine Insurance and Average* (17th ed 2008), p194, para 7-10.

[28] Legh-Jones, Birds and Owen, *MacGillivray on Insurance Law* (11th ed 2008), para 36-36.

[29] J Duer, *The Law of Marine Insurance* (2007), p 214, quoted with approval in *Arnould's Law of Marine Insurance and Average* (17th ed 2008), p 108, para 7-06.

7.51 We do not propose any reforms to the law on when a policyholder may claim against a broker for a failure to exercise reasonable care and skill in fulfilling its duties. That would be outside the ambit of the current project. Where an insurer has avoided the policy under section 19 as a result of the broker's fault, and the policyholder is innocent of wrongdoing, the policyholder would appear to have an action against the broker. That action, however, arises under general law. It does not depend on the wording of section 19.

7.52 In light of the responses we received, we do not think that is helpful to see section 19 in terms of a duty on brokers. Breach of the section does not give a right to damages against the broker for either the policyholder or the insurer. Rather it expands the policyholder's duty of disclosure to include some information known to the broker, even if that information is not known to the policyholder. It needs to be seen in that light.

7.53 In Part 6, we outlined the circumstances in which information is known or ought to be known to the policyholder. Section 19 expands this category to include some circumstances which are known or ought to be known to the broker. The case law suggests, however, that the expansion is a limited one. As we explore below, most consultees agreed that section 19 has a limited ambit and does not extend to confidential information received from third parties.

Should producing brokers be required to pass information up the chain?

7.54 In 2007 we asked several questions about our proposal, including whether producing brokers should be obliged to pass relevant information up the chain to the placing broker. We received forty-one responses to this question, of which thirty-four (83%) were in favour.

7.55 Several consultees expressed concern about how this would work in the context of our original proposal, namely that the insurer would be entitled to sue the placing broker. There was some debate over whether insurers should sue producing brokers directly, or whether the placing broker should have a right to be indemnified by the producing broker. Most consultees agreed however, that all those in the chain of brokers should disclose relevant material facts within their knowledge, and that this should be reflected in the law.

7.56 As we discuss below, we agree. We think that any provisions which require the disclosure of information held by brokers should apply to all those in the chain.

Section 19(a) and confidential information from third parties

7.57 In 2007, we also asked whether the law should specifically state that an intermediary is not required to disclose information given to it in confidence by a third party.[30]

7.58 There were forty responses to this question. Thirty-five agreed that an intermediary should not be required to disclose information given to it in confidence by a third party. Most felt that a change in the statute would clarify the disclosure relationship, though some thought that this was unnecessary.

[30] LCCP 182/SLCDP 134, para 10.74.

7.59 The Lloyd's Market Association said that they struggled to think of any scenario where the issue had ever arisen and therefore questioned the need for the proposal. If section 19 of the 1906 Act were to be taken literally, conflicts of interest might arise frequently, whereby confidential information given by one client would be relevant to the insurer's decision to give cover to a different client facing similar risks.[31] It is clear that in practice section 19 is not interpreted in this way.

7.60 The City of London Law Society argued against our proposal, thinking it might be used inappropriately. They posed the following example:

> Suppose, for example, that a proposed insured, in the course of providing his broker, A, with information necessary to get insurance for his building and his business, tells broker A that he pays a weekly fee to the local Mafia for protection, and broker A's response is: You'll never get cover; forget it. So having learnt his lesson, the proposed insured goes to broker B but says nothing about the protection money. But A learns that B is placing the risk and tells him in confidence about the protection money. Should B not have a duty to disclose the information he has received in confidence? There are difficult conflict issues that present themselves in these types of situations, but that does not necessarily mean that the broker should not have a duty to disclose.

7.61 In this particular case, the insured (C) is clearly aware of the protection money. If it fails to disclose the payments to the insurer, it is in breach of section 18. It is unlikely to matter whether there has also been a breach of section 19.

7.62 Nevertheless, looking again at this example, we think that the information should be disclosed - both on the ground that it is known to the policyholder (under section 18) and on the ground that it is known to the broker (under section 19). This is because the information has been received by the broker in its capacity as acting for the policyholder.

7.63 The position would be very different if another, separate, client in the same street (D) had consulted the broker on its own behalf and had mentioned confidentially that D was paying protection money to the mafia. This might still be relevant to any insurer providing cover for C. Nevertheless, if the broker was obliged to tell C's insurer about D's payments, this would result in a major conflict of interest.

[31] Note that under the FSA Handbook, SYSC 10 an insurance intermediary must take all reasonable steps to identify conflicts of interest, and maintain and operate effective organisational and administrative arrangements to prevent conflicts of interest from constituting or giving rise to a material risk of damage to its clients. See also ICOBS 8.3.3.

7.64 This particular example might be fanciful, but as brokers become larger, they gather increasing information about the risks facing a wide range of companies, together with advance notice of possible claims. Take a case where a major international broker acts for E, which manufactures medical implants. If the broker is told of risks associated with the implants this information may be relevant not only to E's insurer but also to any insurer providing liability cover to clinics using the implant. Again, if the broker acts for a motor manufacturer, F, and receives information suggesting problems with the brakes on its trucks, this may influence the insurer of a haulier using those trucks.

7.65 We do not think that section 19 of the 1906 Act is intended to require this form of disclosure, whereby information received in confidence from one client must be disclosed to the insurer of another client. This interpretation would not be compatible with the normal duties of confidentiality which a broker owes to its clients. We think that section 19 is only intended to apply to information received or held by the broker in its capacity as agent for that policyholder.

Section 19(b)

7.66 In 2007, we noted that section 19(b) of the 1906 Act merely replicated the policyholder's duty under section 18. It did not appear to offer the insurer any rights which were not already granted under that section. *Colinvaux* describes the provision as "almost certainly redundant".[32] For consumer insurance, we asked whether there were any reasons to preserve it.

7.67 The responses we received indicated that the provision was otiose. As Freshfields put it:

> We agree that section 19(b) … does not give the insurer additional protection and therefore there is no reason to preserve it.

Beachcrofts LLP and RBS Insurance also agreed.

7.68 Marsh Mercer Kroll argued strongly that the section should be repealed:

> We believe that section 19(b) is a historical anomaly originally introduced for reasons which no longer apply in the modern world. This provision serves little or no purpose and **we strongly believe it should be repealed in its entirety.** (Their emphasis)

7.69 Below we propose its repeal for business insurance.

PROPOSALS FOR REFORM

7.70 In Part 6, we argued that it was important to clarify whose knowledge is relevant in defining the scope of a policyholder's duty under section 18 of the 1906 Act, as the issue was of considerable practical significance to medium and large companies.

[32] *Colinvaux and Merkin's Insurance Contract Law,* p 10769 at para A-0794.

7.71 We proposed that the attribution of knowledge should not be restricted to the directing mind and will, but should also include knowledge held by employees whose business it was to arrange insurance for the company.[33] This should include not only actual knowledge but also "blind eye" knowledge. In addition, we proposed that a company should be under a duty to make reasonable enquiries before placing insurance: the insurer should have a remedy against a policyholder who fails to disclose information which would have been discovered by those enquiries.

7.72 Our proposals on section 19 of the 1906 Act should be seen in this context. Brokers are frequently involved in enabling businesses to fulfil their disclosure requirements. Where brokers have acted for a client for many years they may know more about the business than the employee involved in organising the insurance. It is therefore right that the duty of disclosure should include not only information known by the employee placing the insurance, but also any information received or held by the agent in the course of acting for the policyholder.

7.73 We think there is a need to clarify that this should include producing, placing and intermediate brokers within its scope. In fact, it is the producing broker who is most likely to know the circumstances of the policyholder's business.

7.74 We think it would also be helpful to clarify that the duty of disclosure only applies to information received or held by that agent in its capacity as agent for the policyholder. It should not include information given to the broker by other clients in relation to other insurers.

7.75 In Part 6, we explained that the information should include information which the persons who arranged the insurance on behalf of the organisation actually knew, together with "blind eye" knowledge. We explained that blind eye knowledge is information which the buyer deliberately avoided acquiring because it preferred not to know or because it would have confirmed a suspicion.[34] We think the same should apply here, in so far as the broker was acting for the policyholder at the time.

7.76 In Part 6, we also proposed that the policyholder should be under a duty to make reasonable enquiries, proportionate to the type of insurance and to the size, nature and complexity of the business. We think that where the broker is involved in this process, the insurer should have a remedy[35] against the policyholder if the broker fails to disclose information which it would have discovered by those reasonable enquiries.

[33] See Part 6, para 6.73 and following.

[34] See Part 6, para 6.29 and following.

[35] We discuss the nature of the remedy in Part 9.

7.77 Finally, section 19(b) of the 1906 Act requires the disclosure of "every material circumstance which the assured is bound to disclose" unless it comes to the broker's knowledge too late. This provision adds nothing to the policyholder's duty of disclosure under section 18 and appears redundant. We propose to repeal it unless there are any good reasons to retain it. We have asked this question in the context of consumer insurance,[36] and now ask it in the context of business insurance.

7.78 **Do consultees agree that**:

(1) There is a need to clarify the scope and nature of section 19(a) of the Marine Insurance Act 1906?

(2) The amended section 19(a) should:

(a) apply to producing, placing and intermediate brokers?

(b) be confined to information received or held by that agent in its capacity as agent for the policyholder?

(c) include information which the broker actually received in its capacity as agent for the policyholder, together with information which the broker deliberately avoided acquiring?

(3) Where the broker is involved in carrying out reasonable enquiries on behalf of the business policyholder, the insurer should have a remedy against a policyholder if the broker fails to disclose information which it would have discovered by those reasonable enquiries?

(4) Section 19(b) should be repealed? We welcome views on whether there are any reasons to preserve this section.

[36] See para 7.39 above.

PART 8
THE INSURER'S KNOWLEDGE

8.1 In Part 6 we considered what a policyholder knows or ought to know in the ordinary course of business. In Part 7 we looked at how far this test extended to circumstances which are known or ought to be known to the broker. Similar issues arise about what the insurer knows or ought to know, as these circumstances need not be disclosed by the policyholder.

THE CURRENT LAW: SECTION 18(3)(b)

8.2 Section 18(3) of the Marine Insurance Act 1906 (the 1906 Act) lists circumstances which need not be disclosed. Section 18(3)(b) relates to circumstances which the insurer knows or ought to know, and reads as follows:

> In the absence of inquiry the following circumstances need not be disclosed, namely:
>
> …
>
> (b) Any circumstance which is known or presumed to be known to the insurer. The insurer is presumed to know matters of common notoriety or knowledge, and matters which an insurer in the ordinary course of his business, as such, ought to know;

8.3 Therefore, a policyholder need not disclose:

(1) matters which the insurer knows;

(2) matters of "common notoriety or knowledge"; or

(3) Matters which an insurer ought to know in the ordinary course of business.

8.4 The subsection operates as a defence to a claim for non-disclosure under sections 18 or 19 of the 1906 Act. The onus is on the policyholder to prove that section 18(3)(b) applies.

8.5 It is important to note that the subsection does not apply to misrepresentations under section 20 of the 1906 Act. If an insurer asks a question about these matters, the policyholder must give a truthful answer. Thus the policyholder is only excused from disclosure "in the absence of enquiry".[1] In practical terms, asking a question may be the most effective way for insurers to overcome any uncertainties surrounding section 18(3)(b).

[1] See *Brotherton v Aseguradora Colseguoros SA (No 3)* [2003] EWHC 1741; [2003] Lloyd's Rep IR 762.

8.6 Section 18(3)(b) has proved complex and its meaning is not entirely clear. We think it is helpful to distinguish between matters of general public knowledge, matters of industry knowledge which an insurer ought to know about, and other matters (such as the policyholder's individual circumstances). Below we look at each in turn.

GENERAL PUBLIC KNOWLEDGE

8.7 Under section 18(3)(b) of the 1906 Act, a prospective insurer is presumed to know "matters of common notoriety or knowledge". As Cockburn CJ said in *Bates v Hewitt*:

> It is also true that when a fact is one of public notoriety, as of war … the party proposing the insurance is not bound to communicate what he is fully warranted in assuming the underwriter already knows.[2]

8.8 In *Carter v Boehm*, Lord Mansfield said that the list of matters which the assured need not mention included:

> … general topics of speculation or every cause which may occasion natural perils, as the difficulty of the voyage, kind of seasons, probability of hurricanes, earthquakes etc; or every cause which may occasion political perils, from the rupture of the States, from war, and the various operations of it, upon the probability of safety from the continuance and return of peace, or from the imbecility of the enemy.[3]

8.9 The standard appears to be an objective one. A major textbook, *MacGillivray*, explains that insurers are credited "with knowledge of matters of public knowledge or notoriety which a generally well-informed person might fairly be expected to know".[4] For example, in *Planche v Fletcher*[5] it was held that the insurer was presumed to know that a war between France and England was imminent. In *Foley v Tabor*[6] the insurer was presumed to know that ships to Karachi often carried iron.

8.10 We think that the current standard is an appropriate one to impose on insurers but that the wording is outdated. "Notoriety" is a word which appears to have altered in meaning over the last 100 years, from "well known" to "infamous". We think it would be simpler to refer to matters of "common knowledge".

INDUSTRY KNOWLEDGE

8.11 An insurer is also presumed to know specialist matters which an insurer in the ordinary course of his business ought to know. In *Noble v Kennoway* Lord Mansfield explained this requirement as follows:

2 (1867) LR 2 QB 595 at 605.

3 (1766) 3 Burr 1905.

4 Legh-Jones, Birds and Owen, *MacGillivray on Insurance Law* (11th ed 2008) at 17-074.

5 (1779) 1 Doug KB 251, 165.

6 (1861) 175 ER 1231, 1232.

> Every underwriter is presumed to be acquainted with the practice of the trade he insures, and whether it is established or not if he does not know it, he ought to inform himself. [7]

8.12 Again, the standard is an objective one. It goes beyond knowledge that an insurer turns a "blind eye" to[8] and requires an insurer to become familiar with the trade it is insuring,[9] restricting the prospective policyholder's duty of disclosure.[10]

8.13 An example of how the subsection operates is *Glencore International AG v Alpina Insurance Co Ltd.*[11] The policyholder was an oil trading company which stored oil with Metro Trading International (MTI). When MTI collapsed financially, the policyholder and other depositors discovered that MTI no longer retained all of their oil deposits but had sold some to meet its debts. The policyholder claimed on its insurance with the defendant to recover its losses. The policy was expressed in very broad terms, providing open cover for all goods in transit as soon as the claimants acquired an interest in them. The defendant declined liability on various grounds, including material non-disclosure of an estimate of throughput of oil in various storage facilities.

8.14 Mr Justice Moore-Bick found for the policyholder, commenting that:

> … when an insurer is asked to write an open cover in favour of a commodity trader he must be taken to be aware of the whole range of circumstances that may arise in the course of carrying on a business of that kind. In the context of worldwide trading the range of circumstances likely to be encountered is inevitably very wide.[12]

8.15 Mr Justice Moore-Bick continued:

> That does not mean that the insured is under no duty of disclosure, of course, but it does mean that the range of circumstances that the prudent underwriter can be presumed to have in mind is very broad and that the insured's duty of disclosure, which extends only to matters which are unusual in the sense that they fall outside the contemplation of the reasonable underwriter familiar with the business of oil trading, is correspondingly limited. [13]

7 (1780) 2 Doug KB 510, 512.

8 M A Clarke, *The Law of Insurance Contracts* (Issue 23, 1 June 2011) 23-9 pp 23-39 citing *Bates v Hewitt* (1867) LR 2 QB 595, 605 by Cockburn CJ.

9 See *Colinvaux & Merkin's Insurance Contract Law*, para A-0895 citing *Vallance v Dewar* (1808) 1 Camp 503 at 508; *Moxon v Atkins* (1812) 3 Camp 200; *Stewart v Bell* (1821) 5 B & Ald 238; *British and Foreign Marine Insurance Co Ltd v Gaunt* [1921] 2 AC 41, 59 to 62.

10 For example, in *Société Anonyme d'Intermediaries Luxembourgeois (SAIL) v Farex Gie* [1995] LRLR 116, Saville LJ treated the relevant test as being simply an objective test of what an insurer ought to know (at 156).

11 [2003] EWHC 2792 (Comm); [2004] 1 Lloyd's Rep 111 at [55].

12 Above at [41].

13 Above at [41].

8.16 The case illustrates that insurers are expected to take positive steps to acquire knowledge of the trade they are insuring.[14] Here the open cover was written in broad terms, so the range of circumstances the underwriter was expected to know was equally broad.

8.17 *MacGillivray* provides further examples of this principle:

> In fidelity cover the assured need not, therefore, state the terms of employment unless there is something unusual in them, and in contracts of reinsurance the original risk will be presumed to be subject to all the clauses and conditions usually inserted in policies covering that particular class of risk. [15]

8.18 Similarly an insurer would be presumed to know what goods a tradesman of a specified class would normally have in his stores.[16]

8.19 Thus, under the current law, the insurer is expected to know the normal practices and risks present in any trade which it underwrites. In the course of discussions, we were given a contemporary example: an underwriter who specialises in insuring ice-cream vans would be expected to know that many ice-cream vans are hand-painted, increasing the costs of collision damage. In other trades, however, the fact that a van was hand-painted may constitute a more unusual risk.

8.20 Again, we think that this is an appropriate standard, though the concept could be expressed more clearly in the legislation.

OTHER KNOWLEDGE

8.21 The subsection also applies to other knowledge, such as information about the policyholder's individual circumstances. Typically, the issue arises when the policyholder has told the insurer information in connection with another policy, or another claim, but that information has not been passed to the underwriter who makes the decision. This raises questions of attribution: whose knowledge is relevant for the purposes of section 18(3)(b), and what procedures should they carry out?

[14] See also *Kingscroft Insurance Company Ltd v Walbrook Insurance Company (No 2)* [2000] 1 All ER (Comm) 272; [1999] Lloyd's Rep IR 603.

[15] Legh-Jones, Birds and Owen, *MacGillivray on Insurance Law* (11th ed 2008) at 17-076.

[16] Above at 17-076 and see *Nicholson v Phoenix* (1880) 45 UCQB 359.

Whose knowledge is attributed to the insurer?

8.22 In Part 6 we considered the general law on attribution of knowledge within corporate organisations. Traditional thinking would impute only the knowledge of individuals who were the organisation's "directing mind and will"[17] (generally directors). More recently however the courts have considered the purpose of each statutory provision, and decided the issue with a view to furthering that purpose.[18]

8.23 For the purposes of section 18(3)(b) of the 1906 Act, the most important person is the person who makes the underwriting decision to fix the premium or determine whether to take the risk. In *Evans v Employers Mutual Insurance Association Ltd*, the relevant decision was delegated to a clerk, and the clerk's knowledge was imputed to the insurers.[19]

8.24 Information will be known to the insurer if it was received by an agent of the insurer who is under an obligation to channel the information to the underwriter in question.[20] As stated by Brett MR in 1885 "the insurer's doorman is not the right channel, nor, in general, is his lawyer".[21] In *Joel v Law Union & Crown Insurance Company,*[22] however, a doctor commissioned by an insurer to examine a prospective policyholder was considered to be the agent of the insurer for the purpose of channelling information. Information which the doctor acquired by his examination was attributed to the insurer.

Information acquired in a different context

8.25 An insurer may receive information relevant to a future proposal before it ever contemplates issuing a policy. Generally an insurer is not to be treated as having actual knowledge of a fact if it has no reason to draw a connection between the policyholder's proposal and information acquired previously.[23]

8.26 For example, in *London General Insurance Co Ltd v General Marine Underwriters' Association Ltd*[24] the reinsurer successfully avoided a policy on the ground of non-disclosure of a casualty despite the fact that it had received the same casualty slip as the reinsured. This was because it received the slip before being offered the risk when the information was of no concern to it.

[17] See Part 6, para 6.14 and following.

[18] Following *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 2 AC 500.

[19] [1936] 1 KB 505.

[20] M A Clarke, *The Law of Insurance Contracts* (Issue 23, 1 June 2011) 23-9A2 pp 23-41.

[21] *Tate v Hyslop* (1885) 15 QBD 368, at 378 by Brett MR, who later became Lord Esher MR.

[22] [1908] 2 KB 863.

[23] For example, see *Bates v Hewitt* (1867) LR 2 QB 595 and Legh-Jones, Birds and Owen, *MacGillivray on Insurance Law* (11th ed 2008) at 17-075.

[24] [1921] 1 KB 104.

8.27 More recently, in *The Grecia Express,*[25] Mr Justice Colman concluded that a policyholder is not entitled to presume that an underwriter will retain knowledge of previous casualties and relate the information to the new policy. This proposition, together with an 18 month delay between the previous casualty and the new risk, led the court to find that the insurer did not know the policyholder was the charterer of the previous vessel despite knowing of the casualty at the time it occurred.

8.28 By contrast, *Cape Plc v Iron Trades Employers Insurance Association Ltd*[26] is an example of the circumstances in which an insurer will be expected to relate information previously received to a new policy. Here the policyholder was a major manufacturer of asbestos products which took out employers' liability insurance with the insurer, Iron Trades. Iron Trades also issued policies to other major asbestos companies. Iron Trades subsequently sought to avoid the policy for the non-disclosure of a series of claims relating to mesothelioma. However, one of those claims was also brought against another company insured by Iron Trades, about which Iron Trades knew. Accordingly, it was held that Iron Trades knew about the claim in the ordinary course of business and could not avoid the policy for the non-disclosure of the claim.[27]

Knowledge of previous dealings

8.29 *Colinvaux* raises the question of whether an insurer is deemed to know about previous dealings between itself and a prospective policyholder or whether these must be disclosed. The writers suggest that it has never been the subject of a firm decision in England.[28]

8.30 The issue has arisen in the context of waiver. In *Mahli v Abbey Life Assurance Co Ltd,*[29] the insurer disclaimed liability on a 1984 life insurance policy on the ground of non-disclosure of the deceased policyholder's alcoholism and malaria. The policyholder's wife claimed that the insurer had waived its right to avoid the policy when it accepted premiums after it had been informed of these circumstances.

8.31 In 1986 the insurers were told about Mr Mahli's medical problems in the context of an application for a second policy, but they failed to relate them to his 1984 application. The underwriter checked the computer system, which noted that Mr Mahli had a previous policy, but failed to find the relevant documents. The court heard expert evidence that it was not the practice of underwriters to check earlier policies: "the pressure of work in the offices is such that this would be quite impracticable". On this basis the majority of the Court of Appeal upheld the trial judges' finding that the insurer did not have constructive knowledge of the non-disclosure when it continued to accept premiums.

[25] [2002] EWHC 203 (Comm); [2002] 2 Lloyd's Rep 88.

[26] [2004] Lloyd's Rep IR 75.

[27] By Rix J at 99.

[28] *Colinvaux & Merkin's Insurance Contract Law* at para A-0896.

[29] [1996] LRLR 237.

8.32 However, Lord Justice McCowan dissented on the grounds that the insurer had all the relevant information in its systems. He accepted that individuals are not expected to personally remember information received, but thought that the insurer should be taken to be aware of information held in its computer system or hard copy file:

> I fail to see why the information in it was not in the knowledge of the company in September 1986 every bit as much as in May 1988 when that company used that knowledge to repudiate the policy. There is no question at either date of the information having been forgotten or lost. [30]

8.33 The decision is fact specific, and it is difficult to draw hard and fast principles. It is clear, however, that the courts are reluctant to find that an insurer has constructive knowledge of the policyholder's circumstances. We think an insurer would be expected to check its computer systems, but is not expected to carry out elaborate or impractical enquiries, or to match information across the organisation.

VIEWS ON THE INSURER'S KNOWLEDGE

8.34 We have not previously asked consultees to comment specifically on section 18(3)(b) of the 1906 Act. Nevertheless, many responses have touched on the point.

8.35 Several agreed that it should be presumed that the underwriter knows something about the field of insurance in which he is prepared to accept risk. As stated by Geoffrey Lloyd and Derrick Cole "it would be wholly illogical if he did not". The Liverpool Underwriters and Maritime Association's response supported the fundamental rationale of section 18(3)(b) – the insurer knows its business:

> The insurer knows the information it requires and knows why it requires that information.

8.36 Similarly, Jardine Lloyd Thompson Group Plc commented:

> Underwriters are sophisticated global risk management experts. They have sector specific knowledge… .

8.37 Several consultees noted that in a digital age, insurers now have access to considerable knowledge. Willis noted that much has changed since the decision of *Carter v Boehm* and in the backdrop against which the 1906 Act was drafted:

> The insurance (and reinsurance) market has evolved significantly since 1776 – *Carter-v-Boehm* – and 1906 – Marine Insurance Act 1906. Modern communication, particularly the internet, has led to a modern professional underwriter being able actively to inform himself about a risk in a way that his predecessors with access to far less information in times when communications were far slower could not. As a consequence, the duty of good faith has developed unevenly and the market should encourage the equalising of the burden.

[30] Above at 245 by McCowan LJ.

8.38 Clyde & Co supported the retention of a duty of disclosure but noted:

> Generally, we believe that the Marine Insurance Act 1906 was designed to deal with market conditions very different from those which prevail today. In particular, whereas in 1906 it may have been accurate to say "the Assured knows everything, the Underwriter nothing" the reality today is that the Underwriter has vastly expanded knowledge or means of knowledge.

8.39 Herbert Smith LLP also emphasised that insurers should inform themselves about matters relevant to the risks they underwrite:

> We recognise that the decision in *Carter v Boehm* is largely of academic interest but, in many respects, Lord Mansfield's statement of the law … highlighted not only the duty of disclosure but also … the onus on the insurer to inform itself about matters relevant to risks it underwrites and the onus on it to ask for more information. In large measure, as the law has developed, it has changed from protecting the able and knowledgeable underwriter to protecting the "nodding donkey".

8.40 The British Maritime Law Association considered section 18(3)(b) of the 1906 Act to be the quid pro quo in terms of fairness to the duty of disclosure on the prospective insured under section 18(1):

> This provision [s18(1)] also simplifies litigation; few assureds would waste time arguing "my people did not tell me" as doing so is futile. It is worth noting that the law is quite even-handed in this respect since s18(3)(b) imposes the same control on the insurer.

8.41 We agree that insurers are sophisticated risk management experts, and it is right that the law should require high standards from them. As we explore below, we think section 18(1) and section 18(3)(b) of the 1906 Act are two sides of the same coin and should be interpreted in equivalent ways.

PROPOSALS FOR REFORM

8.42 Since *Carter v Boehm*, it is clear that the insurer is expected to inform itself about matters relevant to risks it underwrites. It is not entitled to expect the policyholder to disclose matters which it should know already. This principle was included in the Marine Insurance Act 1906 and forms an important counterweight to the duty of disclosure. It needs to be well known and understood.

8.43 The Marine Insurance Act 1906 makes three references to circumstances which "in the ordinary course of business ought to be known". We have argued that the phrase is far from clear. In Part 6, we proposed to clarify what a policyholder knows or ought to know when placing insurance. In Part76 we proposed to clarify what a broker ought to know. We think that it would be helpful to clarify the phrase within this context as well.

8.44 We have identified four main propositions from the current case law. First, in the absence of inquiry, a policyholder need not disclose matters of public, or "common" knowledge.

8.45 Secondly, in the absence of inquiry, a policyholder need not disclose information relating to the practices and risks of the trade which a generally well-informed insurer writing that particular class of business ought to know.

8.46 Thirdly, in the absence of inquiry, the policyholder need not disclose any information which the insurer knows. In Part 6 we argued that it would be helpful to clarify how knowledge should be attributed to a corporate policyholder. The same argument applies here. We think that knowledge can be attributed to an insurer for the purposes of section 18(3)(b) of the 1906 Act if it is known to the directing mind and will of the insurer, or to any staff who are asked to make the underwriting decision.

8.47 Finally, the category of what an insurer knows has been held to include information known to an agent or employee of the insurer, where that information ought to have been communicated to the underwriter. Examples would be a doctor or surveyor commissioned by an insurer to examine a prospective policyholder or site. Such agents ought to communicate their knowledge to the underwriter.

8.48 In some circumstances information may not be communicated because an agent fails to do its job properly. In other cases, the system may fail: for example, information held in computer files may not be retrieved. The courts do not impose onerous obligations in such circumstances. The courts would, however, be reluctant to penalise a policyholder who had acted entirely reasonably in expecting the insurer's surveyor to pass on the information but this did not happen because the insurer's computer system had failed.

8.49 If the insurer is not confident that it can retrieve the relevant information, it is always open to the insurer to ask the proposer a question. Where the policyholder makes a representation of fact, it must be true.[31] Section 18(3)(b) does not apply.

8.50 **Do consultees agree that, in the absence of inquiry, a business policyholder need not disclose**:

(1) Matters of common knowledge?

(2) Information relating to the practices and risks of the trade which a well-informed insurer writing that particular class of business ought to know?

(3) Information which is already known to:

(a) The directing mind and will of the insurers; or to

(b) The persons who make the underwriting decision?

(4) Information held by the insurer's agent or employee which ought to have been communicated to the person making the underwriting decision?

[31] See the discussion of section 20 of the 1906 Act at Part 6, para 6.79 and following.

PART 9
PROPORTIONATE REMEDIES

INTRODUCTION

9.1 At present, the law provides only one remedy for non-disclosure or misrepresentation: avoidance of the contract. The insurer may treat the contract as if it does not exist and refuse all claims under it.

9.2 The criticisms of this approach are three-fold:

(1) Avoidance may be appropriate where an insurer would not have taken the risk at all had it known the truth, but in other circumstances it appears overly harsh. An insurer may, for example, have been happy to take the risk for a higher premium or to have included an additional term, such as a higher excess. Yet avoidance allows the insurer to refuse all claims, including those it might have accepted had the truth been known.

(2) Where courts wish to protect the policyholder against such a harsh remedy, they are forced to find against the insurer and order that the claim is paid in full.[1] In some cases, the insurer may in fact be undercompensated for the policyholder's behaviour.

(3) Such an "all or nothing" remedy encourages litigation and fails to reflect the commercial realities of the situation.

9.3 Where an insurer has not been presented with the full facts, it is right that the insurer should be compensated. Under normal principles of law, that compensation should aim to put the injured party into the position it would have been in had the other party fulfilled its duties. In this Part, we argue the case for proportionate remedies based on this principle.

9.4 We start by outlining our 2007 proposals and the provisions in the Consumer Insurance (Disclosure and Representations) Act 2012. We then analyse the responses we received to the 2007 proposals. We conclude that proportionate remedies should be the default remedy for non-disclosures and misrepresentations which are not dishonest. It should, however, be open to the parties to contract out of proportionate remedies if they wish. We ask for views.

[1] The courts may find, for example, that the insurer was not induced or that it has waived its right to information; see Part 5, para 5.38 and following and para 5.61 and following.

THE 2007 PROPOSALS

9.5 In our 2007 Consultation Paper[2] we argued that avoidance over-protects the insurer against the loss it might have suffered had it paid a claim. We thought avoidance was appropriate where a policyholder had behaved dishonestly, but where the policyholder had been merely negligent, we considered that the remedy should be based on what the insurer would have done had it known the truth. We pointed out that in consumer insurance, the Financial Ombudsman Service already applied proportionate remedies for careless misrepresentations, and asked if a similar approach should be taken in business insurance.

9.6 We proposed that where the insurer could show that the policyholder had acted dishonestly it should be entitled to avoid the contract, refuse all claims and retain any premiums paid.

9.7 For negligent conduct, the remedy should depend on what the insurer would have done had it known the true facts.[3] In particular:

(1) where the insurer would have declined the risk altogether, the policy should be avoided, the claim refused and the premiums returned;

(2) where the insurer would have excluded a particular type of claim, the insurer should not be obliged to pay claims that would fall within the exclusion;

(3) where the insurer would have imposed a warranty or excess, the claim should be treated as if the policy included the warranty or excess; and/or

(4) where the insurer would have demanded a greater premium, the claim should be reduced proportionately to the under-payment of the premium. For example, if the insurer would have charged double the premium, it need only pay half the claim.

9.8 In 2007, we also proposed that business policyholders who acted honestly and reasonably should be protected. In particular, we thought that the policyholder should only be required to disclose information which a reasonable insured would think was relevant to the insurer.[4] We therefore argued that policyholders who had behaved "innocently" should have their claims paid in full.

9.9 It is important to note that we are no longer proceeding with the reasonable insured test. Our current proposals, therefore, make no distinction between "negligent" and "innocent" conduct. Instead, proportionate remedies would apply to all actionable non-disclosures or misrepresentations which were not dishonest.

[2] Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured (2007) LCCP 182/SLCDP 134.

[3] Above, at para 4.153 and following.

[4] Above, at para 5.83.

REFORMS IN CONSUMER INSURANCE

9.10 For consumer insurance, there was widespread agreement that these remedies should be given a statutory basis. The Consumer Insurance (Disclosure and Representations) Act 2012 now includes proportionate remedies as the main remedy for careless misrepresentations.[5]

9.11 These remedies are set out in schedule 1 of the new Act. Under paragraph 2, if the misrepresentation was deliberate or reckless, the insurer:

(a) may avoid the contract and refuse all claims, and

(b) need not return any of the premiums paid, except to the extent (if any) that it would be unfair to the consumer to retain them.

9.12 Where the misrepresentation is careless, paragraphs 5 to 7 apply. They state that:

> (5) If the insurer would not have entered into the consumer insurance contract on any terms, the insurer may avoid the contract and refuse all claims, but must return the premiums paid.
>
> (6) If the insurer would have entered into the consumer insurance contract, but on different terms (excluding terms relating to the premium), the contract is to be treated as if it had been entered into on those different terms if the insurer so requires.
>
> (7) In addition, if the insurer would have entered into the consumer insurance contract (whether the terms relating to matters other than the premium would have been the same or different), but would have charged a higher premium, the insurer may reduce proportionately the amount to be paid on a claim.

9.13 In our 2009 Report on consumer insurance, we gave more details about how proportionate remedies would apply.[6] We explained that the aim of a proportionate remedy is to put the insurer in the position in which it would have been had the consumer complied with the duty to answer questions honestly and reasonably. The remedies do not relate to the consumer's degree of fault. Instead the remedies are designed to compensate the insurer for any loss it has suffered.

9.14 In Appendix B we explained how proportionate remedies would apply in complex cases; for example, where two insurers had insured the same risk; or where the policyholder receives an insurance payment and is then compensated for the same loss by a third party. Although some of these scenarios can be mathematically complicated, we thought that the current law reached the right outcome. There was no need for separate provisions to cover them.

[5] 2012 c 6.

[6] Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation (2009) Law Com No 319/Scot Law Com No 219.

PROPORTIONATE REMEDIES IN BUSINESS INSURANCE: CONSULTEES' VIEWS

Support for proportionate remedies

9.15 A majority of consultees supported the introduction of proportionate remedies in business insurance, though support was less strong than for consumer insurance. In all, 61 respondents gave their views on this question. Of those, 36 thought that the law on business insurance should distinguish between dishonest and negligent conduct, and that a compensatory remedy should apply in cases of negligent behaviour.

9.16 As K&L Gates put it:

> … the remedy of avoidance involves over-compensating insurers for the loss suffered and should be restricted to circumstances where the misrepresentation/non-disclosure was dishonest.

9.17 The Law Reform Committee of the Bar Council said:

> It is our view that a careless insured should be penalised for negligent misrepresentation or non-disclosure, and this can be dealt with by applying "proportionate" remedies.

9.18 Freshfields also thought that proportionate remedies would be an adequate disincentive to negligent conduct:

> It is not felt that any stronger incentives are required to prevent negligent behaviour; the possibility of a significantly reduced claim should prove sufficient.

9.19 The Commercial Court Users Working Party described avoidance as an "all or nothing" remedy:

> It is accepted that the "all or nothing" nature of the avoidance remedy may lead to a disproportionate result. Insurers can find themselves in the situation of having to avoid a policy, in circumstances where they do not wish to do so, because no other remedy is available.

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

9.21 We understand from discussions with those in the insurance industry that some insurers already operate an informal system of proportionate remedies. For example, where the insurer on discovering the true facts would still have provided cover but capped any pay out for loss or imposed a higher excess figure, this then forms the basis for negotiations. We also understand that in practice many underwriters do not seek avoidance of the contract unless dishonesty by the policyholder is suspected.

Concerns about proportionate remedies

9.22 Twenty consultees argued that the remedy of avoidance should continue to apply in cases of negligent behaviour. While many insurers in the volume market supported proportionate remedies, those in the specialist areas generally wished to retain the remedy of avoidance.

9.23 It was argued that avoidance provides an incentive for full disclosure. For instance, BILA argued:

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

9.24 This response may, however, have been influenced by the distinction we made in 2007 between innocent and negligent conduct, which no longer forms part of our proposals.

9.25 Kendall Freeman collated views expressed by their clients and other members of the industry. They thought that the threat of avoidance not only gave a strong incentive to disclose information, but could also be used by insurers to obtain favourable settlements:

> Whilst contributors noted that in practice it was rare for an insurer to avoid for innocent, or even negligent, misrepresentation or non-disclosure, the threat of being able to apply an avoidance remedy was sometimes a useful tool in settling disputes. It was suggested that the threat of avoidance gave a stronger incentive to business insureds, who are more likely than consumers to understand the implications of their actions, not to behave negligently.

9.26 Respondents also saw practical problems in applying proportionate remedies to business insurance. Policies are more likely to be bespoke and evidence is not necessarily available to show how insurers would have acted had they known the true facts. Even some of those who supported proportionate remedies thought it would be difficult to establish what an insurer would have done. For example, K&L Gates foresaw speculation about what an insurer might have done had they known the true facts, particularly in the case of “non-standard” risks.

9.27 The City of London Law Society canvassed the views of its members and explained that these were mixed. Some members thought that, unlike consumers, business policyholders were more likely to be aware of what was required of them, while others thought that proportionate remedies were preferable as the default regime: “if insurers wanted to enjoy a stronger position it would be open to them to bargain for such a position by the terms of the contract”.

OUR CURRENT PROPOSALS

The case for proportionate remedies

9.28 We have considered this issue again in the light of the responses we received and recent evidence about the extent of non-disclosure. It is clear from the evidence presented in Part 4 that non-disclosure is widespread, but most is not deliberate or dishonest. Companies are often unaware of the full extent of their duty to volunteer information, and many do not understand what would influence a prudent insurer. In addition it may simply be impossible for a large multi-national company to be certain that all the relevant information has been disclosed. Given this, we think that the remedy of avoidance is overly harsh. It is appropriate where the insurer would not have written the risk at all, but where the insurer would have written the risk on different terms, avoidance over-protects the insurer for the loss it might suffer.

9.29 Good disclosure requires co-operation from both sides: policyholders need to collect better information and insurers need to do more, individually and collectively, to explain what they need to be told. The remedy of avoidance may not do enough to incentivise insurers to encourage better disclosure by, for example, producing protocols of what should be included and asking appropriate questions.

9.30 It is clear that in most cases avoidance is used only as a threat: the parties eventually come to a negotiated solution. Kendall Freeman explained that insurers regard avoidance as a "useful tool in settling disputes". Unfortunately, it may be useful in the same way as a blunderbuss was useful in dispute-settlement. The threat of avoidance is so powerful that it may produce settlements which are unduly low. And in some cases, when the courts are faced with an "all or nothing" solution, they may be reluctant to allow the insurer to fire the weapon. Faced with a clearly unfair result, the court may find that there has been no inducement, or that the insurer has waived its right to the information. In such circumstances, the policyholder will recover its entire claim.

9.31 We think that avoidance may also encourage an unduly adversarial approach, whereby the parties to the dispute argue for "all" or "nothing". Proportionate remedies may focus the minds of the parties on the central issue, namely the quantum of the payment.

9.32 We accept that in some cases it may be difficult to establish exactly what an insurer would have done had it known the information. The court will need to hear the evidence and subject it to scrutiny. The courts are already used to deciding issues of inducement. As Mr Justice Colman noted in *North Star Shipping:*

> In evaluating the underwriters' evidence it is important to keep firmly in mind that all their evidence is necessarily hypothetical and that hypothetical evidence by its very nature lends itself to exaggeration and embellishment […] such evidence has to be rigorously tested by reference to logical self-consistency, and to such independent evidence as may be available.[7]

9.33 Proportionate remedies take the same approach one step further, by looking not only at whether the insurer would have done something different, but what that difference would have been. We accept that in some cases, the result will be imprecise, but we think it is better to aim imprecisely at the right target than precisely at the wrong target. Proportionate remedies are the neutral solution to compensating the insurer for its loss; such remedies are therefore the most appropriate default regime.

9.34 Proportionate remedies may not be suited for particularly specialist areas. That is why we propose to introduce them as a default regime. The parties would be entitled to contract out of proportionate remedies if they wished to do so.

How would proportionate remedies work?

9.35 Proportionate remedies focus on the contract that the insurer would have entered into with the policyholder if the policyholder had fully complied with its duty of disclosure or had not misrepresented information.

9.36 If there would not have been any contract at all, then the insurer may avoid the contract, and simply return any premiums paid. If the insurer would have written other terms into the contract, then the contract is treated as if it contained those terms. If the insurer would have charged a higher premium, then the amount of the claim is reduced proportionately. This is the default position; it will be open to the parties to contract out of what is proposed and make alternative provision for the consequence of breach of the duty to disclose.[8]

9.37 Proportionate remedies do not look at other things the insurer might have done, such as to take out reinsurance or reinsure on different terms. The focus is simply on the insurer's contract with the policyholder. Of course, if the insurer had taken out additional reinsurance it would almost certainly have charged the policyholder more, and this will be reflected in a reduced claim.

9.38 What proportionate remedies do not do is calculate the payment to the policyholder on the basis of what might or might not have happened at each stage in the reinsurance chain. If that were the case, the payment to the policyholder would need to be delayed until each reinsurer had calculated what it might have done in the circumstances. This would be neither principled nor practicable.

[7] *North Star Shipping Ltd v Sphere Drake Insurance Plc* [2005] EWHC 665 (Comm); [2005] 2 Lloyd's Rep 76, affirmed by the Court of Appeal [2006] EWCA Civ 378; [2006] 2 Lloyd's Rep 183.

[8] See further para 9.77 and following.

9.39 **Do consultees agree that, where the policyholder's conduct is not dishonest, proportionate remedies should be the default regime for non-disclosure and misrepresentation in business insurance?**

9.40 **Do consultees agree that the remedy should focus on the contract that the insurer would have entered into with the policyholder if the policyholder had fully complied with its duty of disclosure? In particular**:

(1) If the insurer would not have entered into the insurance contract at all, the insurer may avoid the contract?

(2) If the insurer would have entered into the contract on different terms (excluding the premium), the contract is to be treated as if it included those terms?

(3) If the insurer would have charged a higher premium, the insurer may reduce proportionately the amount to be paid on a claim (which may be additional to the inclusion of other terms)?

THE EFFECT ON REINSURANCE

What if the reinsurer would have taken a different approach?

9.41 We have considered what would happen if the insurer and reinsurer would have taken different approaches to the risk, had each known the full facts. Suppose, for example, the insurer charged £10,000 but had it known a particular fact it would have charged £15,000. On this basis, the insurer would be required to pay 67% of the claim.[9] It has reinsured 80% of the risk with a reinsurer, but the reinsurer might argue that it would have charged an even higher premium if it had known the information (say an additional 75% on the premium rather than merely 50%). Is the reinsurer entitled to pay a smaller proportion to the insurer than the insurer is required to pay to the policyholder?

9.42 The answer depends on whether the reinsurance had been written "back to back" with the original insurance. If it is written back to back, the reinsurer is effectively required to pay 80% of the insurer's liability, which in this case would be 54% of the full claim.

Back to back reinsurance: the current law

9.43 There has been considerable debate over whether the parties to a reinsurance contract have a presumed intention that the contract is made on a back to back basis. In *Vesta v Butcher* Lord Griffiths assumed that reinsurance is nearly always written on this basis. He said:

[9] The calculation is as follows 10,000/15,000 x 100.

> In the ordinary course of business reinsurance is referred to as "back to back" with the insurance, which means that the reinsurer agrees that if the insurer is liable under the policy the reinsurer will accept liability to pay whatever percentage of the claim he has agreed to reinsure. A reinsurer could of course, make a special contract with the insurer and agree only to reinsure some of the risks covered by the policy of insurance, leaving the insurer to bear the full costs of the other risks. Such a contract would be … wholly exceptional.[10]

9.44 This statement must now be read subject to the subsequent decision of the House of Lords in *WASA International Insurance Co Ltd v Lexington Insurance Co.*[11] Here Lord Mance described *Vesta* as "a sensible principle of construction" but it:

> … cannot be made into an inflexible rule of law, which would impose on reinsurers a liability for which, under the law applicable to the reinsurance, they did not bargain.[12]

9.45 The facts in *WASA* were exceptional. Lexington, a US company, insured the Aluminium Company of America (ALCOA) and then obtained reinsurance on the London market. The original policy covered the period 1 July 1977 to 1 July 1980. The reinsurance, which was governed by English law, covered the same risks as the original insurance and for the same period. Both contracts were "losses occurring during" (LOD) policies.

9.46 The US courts found that ALCOA was liable for contamination caused by its activities in various sites across America over 44 years. Applying Pennsylvanian law, the Supreme Court of Washington State held that ALCOA's insurers were liable for the remedial costs of cleaning up all the environmental damage which was manifested during the policy period, whether it occurred within the insured period or not.

9.47 Lexington sought to recover from its reinsurers, WASA, arguing that the reinsurance policy was back to back with the insurance policy. WASA countered that the reinsurance must be construed on its own terms: there was not always a presumed intention that reinsurance was written on a back to back basis. In this case the reinsurance only covered losses which occurred during the three year period.

9.48 The House of Lords found for the reinsurers. Lord Mance emphasised that if back to back insurance was wanted, clear drafting should be used. He explained that the extent to which the contracts of insurance and reinsurance had like effect was determined "by reference to the circumstances and terms in which they were entered, not on the basis that the reinsurance was bound to respond to whatever liability the insurers might subsequently be held to incur".

[10] [1989] 1 All ER 402 at 407.

[11] [2009] UKHL 40, [2010] 1 AC 180.

[12] [2009] UKHL 40 [51]; [2010] 1 AC 180 at 206.

If insurance is not back to back: a problem in non-disclosure disputes?

9.49 In theory, under current law, if reinsurance is not written on a back to back basis, there would be many ways in which the reinsurer would be entitled to refuse claims which the insurer was liable to pay. For example:

(1) The insurer may not have been induced to the enter the contract, while the reinsurer may have been;

(2) The insurer may have waived the non-disclosure by, for example, asking only limited questions or failing to ask the questions a reasonable insurer would have asked;

(3) Where the direct insurance is with a consumer, the insurer may be required to pay the claim by the Financial Ombudsman Service, applying its fair and reasonable jurisdiction;

(4) The insurance may be written under a civil law system which applies proportionate remedies, while the reinsurance may be written under UK law;

(5) The insurance may be written under another legal system which is more favourable to the policyholder. As we explained in Part 3, for example, the Australian courts would apply a reasonable insured test, while under New York law, the insurer would find it difficult to succeed in a claim for non-disclosure where it failed to ask questions.

9.50 In practice, the reinsurance market is able to cope with these issues now. We understand that where the insurer is liable to pay the claim, the reinsurers will provide payment, provided that liability is clearly established and the insurer is not at fault. For routine matters of this kind, reinsurance is almost always effectively written on a back to back basis.

9.51 The introduction of proportionate remedies would be simply an additional development of the inducement test. We think that the reinsurance market will accommodate proportionate remedies in the same way as it accommodates the inducement test, foreign law and other differences in the way that disclosure might affect insurers and reinsurers.

9.52 That said, our proposals permit freedom of contract. If insurers and reinsurers wish to reach other agreements, they would be free to do so.

9.53 **Do consultees agree that the effect of a proportionate remedy on reinsurance can be left to freedom of contract between insurers and reinsurers?**

CANCELLATION FOR THE FUTURE

9.54 Most disputes about non-disclosure are in the context of a claim. Nevertheless, where an insurer has the right to apply a proportionate remedy, the question arises whether it should also have the right to cancel the contract for the future.

The 2007 proposal and respondents' views

9.55 In 2007, we proposed that where the insurer became aware of a negligent misrepresentation or non-disclosure, in addition to the remedies as regards claims, it should also have the right to cancel the policy for the future, after reasonable notice. Forty-seven consultees gave their views on this question and thirty-one agreed with the proposal. Two of those respondents agreed subject to adopting an appropriate definition of "reasonable notice". Peter Franklin, a broker, said that at least a month would be needed to find alternative cover for even simple risks.

9.56 Those who disagreed with this proposal felt that it would be better for insurers to be able to terminate the policy immediately. The Liverpool Underwriters & Marine Association said that underwriters should be able to give notice of termination with immediate effect, as their experience has shown that advance notice of cancellation prompts claims.

The approach for consumer insurance

9.57 The Consumer Insurance (Disclosure and Representations) Act 2012 includes specific provisions dealing with the effect of a negligent misrepresentation on future cover. Under Schedule 1, paragraph 9(4), for non-life insurance, where the insurer discovers a right to reduce a claim proportionately, it may either:

(a) give notice to that effect to the consumer, or

(b) terminate the contract by giving reasonable notice to the consumer.[13]

9.58 A consumer who discovers that the insurer is no longer bound to pay claims in full may no longer wish to continue with the contract. As we explained in the 2009 Report, a consumer may not wish to continue private medical insurance which would only pay half the cost of an operation.[14] The 2012 Act therefore provides that where a consumer receives notice under paragraph 9(4)(a), the consumer also has a right to terminate the contract, by giving reasonable notice to the insurer.

9.59 If either party terminates the contract in this way, the insurer must refund any premiums paid for the terminated cover in respect of the balance of the contract term.[15]

Our current proposals

9.60 We think that it is right in principle that where the insurer has been induced to enter into a contract as a result of a non-disclosure or misrepresentation it should be entitled to cancel the contract for the future. The only question is whether it is necessary to provide a specific statutory right to cancel in these circumstances. We have been told that insurers often include rights to cancel in their contracts in any event.

[13] Sch 1, para 9(4).

[14] Law Com No 319/Scot Law Com No 219, para 6.88.

[15] Consumer Insurance (Disclosure and Representations) Act 2012, sch 1, para 9(7).

9.61 We would also welcome views on whether it is necessary to provide a policyholder with a right to cancel on reasonable notice where they discover that the insurance will not provide them with the cover they anticipated because the insurer intends to apply a proportionate remedy.

9.62 **Where an insurer is entitled to apply a proportionate remedy to a claim, should the statute provide that:**

(1) the insurer has the right to cancel on reasonable notice; and

(2) the policyholder has the right to cancel on reasonable notice?

DISHONEST CONDUCT

Defining dishonest conduct

9.63 In responses to our 2007 Consultation Paper, there was general agreement that avoidance should continue to be available where the policyholder has behaved dishonestly. As Derrick Cole and Geoffrey Lloyd put it:

> We consider the law should distinguish between dishonest and negligent misrepresentation/disclosure. We regard "dishonest" to be "fraudulent" and should entitle the insurer to avoid the contract.

9.64 This leaves the question of how dishonest conduct should be defined. There are two approaches. The first would be to refer to fraudulent conduct, and leave this to the courts to define in accordance with the existing law.[16]

9.65 The second would be to follow the approach taken in the Consumer Insurance (Disclosure and Representations) Act 2012,[17] and provide a stand-alone definition of "deliberate or reckless" conduct. For consumer insurance, many insurers expressed concern that it would be too difficult to prove fraud, and thought it would be preferable to meet a stand-alone test.

9.66 Section 5(2) of the 2012 Act therefore states that a qualifying misrepresentation is deliberate or reckless if the consumer:

(a) knew that it was untrue or misleading, or did not care whether or not it was untrue or misleading, and

(b) knew that the matter to which the misrepresentation related was relevant to the insurer, or did not care whether or not it was relevant to the insurer.

9.67 This definition could be adapted to cover both non-disclosure and misrepresentation to say that conduct is deliberate or reckless if the proposer:

(a) had actual knowledge of the relevant facts (or shut its eyes to the relevant facts); and

[16] See in particular *Derry v Peek* (1889) LR 14 App Cas 337.

[17] 2012 c 6.

(b) (in the case of omissions) knew that the facts were relevant to the insurer, or did not care whether or not they were relevant to the insurer.

9.68 We welcome views on this issue. Fraud is a simple, well-established test, which does not involve creating new concepts. On the other hand, insurers may find it easier to prove that conduct is "deliberate or reckless", and the test would be similar (if not identical) to that used in consumer insurance law.

Should the insurer be entitled to keep the premiums?

9.69 Avoidance normally requires restitution: the parties must be restored to the positions they were in prior to the contract being made. In most cases, the policyholder is entitled to the return of any premium paid, but there is an exception in the case of fraud. For marine insurance, section 84(3)(a) of the 1906 Act states:

> Where the policy is void, or is avoided by the insurer as from the commencement of the risk, the premium is returnable, provided that there has been no fraud or illegality on the part of the assured... .

9.70 For non-marine insurance, the point is not wholly clear, and depends on general principles of contract law or the law of unjustified enrichment.[18]

9.71 For consumer insurance, the 2012 Act provides that where a qualifying misrepresentation was deliberate or reckless, the insurer:

> … need not return any of the premiums paid, except to the extent (if any) that it would be unfair to the consumer to retain them.[19]

9.72 In our 2009 Report on consumer insurance,[20] we explained that it may be unfair to the consumer for the insurer to retain premiums in investment-type life insurance or in joint policies, where only one joint policyholder has been dishonest.

9.73 For business insurance we do not think that where the policyholder has acted deliberately or recklessly there is any need to give the court a discretion to require the insurer to return premiums. Instead, we think that the statute should clarify that where the policyholder has acted deliberately or recklessly the insurer need not return any of the premiums paid.

9.74 **Do consultees think that the statute should provide a specific definition of "deliberate or reckless" non-disclosure and misrepresentation? Alternatively, should the statute refer to fraudulent conduct and leave this to the courts to define in accordance with the existing law?**

9.75 **If deliberate or reckless conduct should be defined, should it be defined as conduct where the proposer:**

[18] See *Berg v Sadler & Moore* [1937] 2 KB 158; *Clough v London and North Western Railway Co* (1871-72) LR 7 Ex 26; and *Standard Life Assurance Co v Weems* (1884) 11 R (HL) 48.

[19] 2012 c 6, sch 1, para 2(b).

[20] Law Com No 319/Scot Law Com No 219, at para 6.40 and following.

(1) had actual knowledge of the relevant facts (or shut its eyes to the relevant facts); and

(2) (in the case of omissions) knew that the facts were relevant to the insurer, or did not care whether or not they were relevant to the insurer?

9.76 **Where the proposer has behaved deliberately or recklessly, do consultees agree that the insurer should be entitled to:**

(1) avoid the policy and refuse all claims; and

(2) keep any premium paid?

CONTRACTING OUT

The 2007 proposals and respondents' views

9.77 In 2007, we proposed that the parties to business insurance should be entitled to contract out of most of the proposed reforms. Sixty-two consultees gave their views on this proposal and thirty-eight agreed that contracting out should be permitted. Several respondents felt that the current law would be preferable in certain markets, and that the parties should have the freedom to preserve the current position.

9.78 Munich Re UK Life Branch put the point as follows:

> We feel this is vital to ensure freedom of contract and the required level of flexibility, especially at the reinsurance level.

9.79 The Leeds Marine Insurance Association agreed:

> We don't think there should be a new regime for business but if there is, we should be able to contract out of it. The system works perfectly well currently and should be maintained in the interest of free trade.

9.80 Others argued against contracting out, on the basis that insurers would be able to use their bargaining power to insist on a return to the current position. K&L Gates, insurance lawyers who represent policyholders only, made the point as follows:

> This assumes that both parties have the freedom to choose the terms they want whereas, in practice, many business insureds do not have the option (or are sufficiently well informed) to suggest alternative terms.

9.81 Some respondents suggested that insurers would contract out of the proposals so often that the whole reform would be rendered nugatory. For example, Beachcroft LLP set out the views of their clients:

Some view the proposals of a default regime as a step in the right direction towards ensuring fair terms. However, others believe that no reform is necessary and that the burden should remain on businesses to obtain advice on the terms of their insurance policy. This latter group view the proposals as having no effect/benefit as insurers are likely to opt out of the default regime and such reforms will therefore simply create an unwarranted expense.

Our current proposals

9.82 We think that the parties should be entitled to contract out of proportionate remedies. In some specialist markets there may be a case for retaining avoidance as the remedy for all non-disclosure and misrepresentation, if the parties wish to do so. We do not intend to interfere with this freedom to contract.

9.83 That said, we do not think that the parties will agree to avoidance routinely in most cases. We understand that many policyholders would welcome fairer remedies, and in a soft market insurers may not find it easy to obtain agreement to automatic avoidance.

9.84 We also propose a safeguard to make sure that policyholders are aware of any term changing the default regime. We propose that the parties can contract out of the default regime, but only through a contract written in clear unambiguous terms and specifically brought to the attention of the other party. This is similar to the safeguards we proposed in other areas, notably contracting out of our proposed default regime on fraudulent claims and on breach of warranty.[21]

9.85 **Do consultees agree that:**

(1) The parties to a business insurance contract should be entitled to contract out of the proportionate remedies for non-disclosure and misrepresentation through a contract term; but

(2) that such a term is only effective if it is written in clear, unambiguous language and specifically brought to the attention of the other party before the contract is formed?

[21] See Part 15, para 15.54 and following and see Insurance Contract Law: Post Contract Duties and other Issues (2011) LCCP 201/ SLCDP 152, Part 8, para 8.24 and following.

PART 10
THE DUTY OF GOOD FAITH

INTRODUCTION

10.1 Section 17 of the Marine Insurance Act 1906 (the 1906 Act) imposes duties of good faith on both parties. It states:

> 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.

10.2 This is a general principle. Sections 18 to 20 of the 1906 Act are specific examples of that principle in relation to non-disclosure and misrepresentation.

10.3 In the course of our review, we have considered section 17 on several occasions. It has a wider application outside a policyholder's duty to disclose information. The duty imposed by section 17 is a reciprocal one: it must be observed by the insurer as well as the policyholder. It also applies both before and after the contract has been formed, though in a post-contract context, there is considerable uncertainty over its effect.[1]

10.4 The main problem with section 17 is that it provides only one remedy: avoidance of the contract. This does not help a policyholder with a claim who seeks a remedy against the insurer. Furthermore, where the policyholder is at fault, it is often a harsh consequence. It is not compatible with the proportionate remedies we propose in Part 9. Nor is it compatible with the remedies for fraudulent claims we proposed in our 2011 Consultation Paper.[2]

10.5 As we discuss below, we think that the duty of good faith is important as a general interpretative principle but we do not think it should, in itself, give either a policyholder or an insurer a cause of action. Any remedies which are required, such as remedies for non-disclosure, misrepresentation or fraudulent claims, should be specified directly in the legislation.

[1] See *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd and Others (The Star Sea)* [2001] UKHL 1; [2003] 1 AC 469. This is discussed in Insurance Contract Law: Post Contract Duties and other Issues (2011) LCCP 201/SLCDP 152 at paras 6.28 to 6.36.

[2] Insurance Contract Law: Post Contract Duties and other Issues; (2011) LCCP 201/SLCDP 152, Part 8.

THE EFFECT OF SECTION 17 IN DIFFERENT CONTEXTS

The insurer's duty of good faith

10.6 In Issues Paper 6 we considered the insurer's duty of good faith and asked if the law should be reformed to provide policyholders with a claim for damages against an insurer who acted in bad faith.[3] Many consultees expressed concern about such a development. They feared that, however limited the right initially, it would soon develop along the lines of the doctrine of good faith in the United States, with substantial damages being awarded against insurers.[4]

10.7 In our 2011 Consultation Paper we said that section 17 of the 1906 Act should not give policyholders a right of action against insurers. It should be seen as a "shield rather than a sword".[5] Thus a policyholder should not be entitled to sue an insurer under section 17 for damages.

Remedies for fraudulent claims

10.8 We examined the insured's post contract duty of good faith in Issues Paper 7.[6] The clearest example of the insured's lack of good faith is submitting a fraudulent claim.

10.9 In the 2011 Consultation Paper we argued that policyholders should suffer a penalty for fraud, but the penalty should not be avoidance of the contract. Instead, we proposed that the policyholder should forfeit the whole claim to which the fraud relates, together with any subsequent claim. We also said that in some cases the insurer should have a right to claim damages for costs actually and reasonably incurred in investigating the claim.[7]

10.10 This has implications for section 17 of the 1906 Act. We would need to remove the statement that "if the utmost good faith be not observed by either party, the contract may be avoided by the other party". Instead, specific remedies for fraudulent claims would need to be written into the legislation.

[3] Issues Paper 6: Damages for Late Payment and the Insurer's Duty of Good Faith (March 2010), paras 9.26 to 9.30. For a discussion of the current law, see Issues Paper 6, Part 4.

[4] A summary of responses to Issues Paper 6 was published in November 2010, and is available on our websites.

[5] Insurance Contract Law: Post Contract Duties and other Issues (2011) LCCP 201/SLCDP 152, para 4.40.

[6] Issues Paper 7: The Insured's Post-Contract Duty of Good Faith (July 2012).

[7] Insurance Contract Law: Post Contract Duties and other Issues (2011) LCCP 201/SLCDP 152, Part 8.

Notification of risk clauses

10.11 In Issues Paper 7 we also considered terms which require the insured to notify the insurer of increases in the risk. Although these are commonly used in civil law countries, the UK approach has been to interpret them restrictively.[8] In an annual policy, the insurer is expected to define the risk precisely, and to continue to cover the risk specified for the contract period. Thus if an insurer wishes to protect itself against, for example, premises being left unoccupied, the normal approach would be to exclude unoccupied premises from cover, unless the insurer agrees a variation in the policy terms.

10.12 In *Commercial Union Assurance Co Ltd v Niger Co Ltd,*[9] Lord Sumner rejected the possibility that a failure to comply with a notification term breached the duty of good faith. We do not think that section 17 of the 1906 Act is needed to give insurers a specific remedy for breach of a notification clause. In particular, it does not give an insurer the right to avoid a policy for breach of a notification clause.

10.13 Most consultees agreed that the courts take the right approach to such clauses and that there is no need for statutory reform. We are satisfied that if we were to remove the reference to avoidance from section 17, we would not affect the law in this area.

Other possible uses of avoidance for lack of good faith

10.14 Finally, in Issues Paper 7 we asked about any other possible effect of section 17 of the 1906 Act in a post-contract context. We did not identify any other examples where the insured's post-contract conduct provides the insurer with the right to avoid the contract under section 17. We noted, however, that the courts might conceivably develop the insured's post-contract duty of good faith in new and unexpected ways.

10.15 We asked if the duty of good faith in section 17 should continue to have some general but unspecified effect. We thought that a general duty might permit the courts to develop the law to meet new challenges. Alternatively, it could add to confusion and uncertainty.

10.16 Views were split on this issue: 15 of 22 consultees argued that good faith should retain a general effect throughout the contract. As Zurich Insurance plc put it:

> The duty of utmost good faith is closely allied to that of moral hazard. Whilst both may be regarded as unspecific, given the unique nature of an insurance contract both are essential in protecting the insurer against the unscrupulous or indifferent policyholder. The duty of utmost good faith extends to the provision of accurate and honest information regarding the circumstances of the claim, it supports the policyholder's obligation to take reasonable precautions to minimise potential exposure to loss and to comply with the general conditions regarding claim notification.

[8] See, for example, *Kausar v Eagle Star Insurance Co Ltd* [2000] Lloyd's Rep IR 154.

[9] (1922) 13 LI L Rep 75, 82.

10.17 By contrast, 7 of 22 consultees thought that the post-contract duty of good faith should be limited to fraudulent claims. As Geoff Lord put it:

> The duty of good faith post-inception should be confined to a duty not to make fraudulent claims; its use elsewhere has created nothing but difficulty.

10.18 Professor Rob Merkin said:

> The notion that there can be any avoidance remedy for post-contract matters brings English law into disrepute. Anything happening post-contract should be the subject of express terms or, if none, implied terms (and the courts have rightly been unwilling to imply very much when insurers are perfectly capable of looking after themselves – see, eg, *Bonner v Cox*).

PROPOSALS FOR REFORM

An interpretative principle

10.19 We propose to amend section 17 of the 1906 Act to remove the statement that, if good faith is not observed, "the contract may be avoided by the other party". Good faith would remain as a general interpretative principle but would not, in itself, give rise to any cause of action.

10.20 In our 2011 Consultation Paper, we summarised a series of cases in which the courts have prevented an insurer from exercising an apparent right because the remedy was not exercised in good faith.[10] We intend that the courts should continue to use the duty of good faith in this way. We do not think, however, that the policyholder should be entitled to damages from the insurer, or that the insurer should have an additional remedy against the policyholder, other than those already established in law.

10.21 Many legal systems recognise the idea of good faith as a way of interpreting legal obligations. Many, for example, recognise the United Nations Convention on Contracts for the International Sale of Goods (the Vienna Convention) which states that:

> In the interpretation of this Convention, regard is to be had to … the observance of good faith in international trade.[11]

In an insurance context, section 17 of the 1906 Act would operate in a similar way as a useful tool to interpret the terms of a contract and the obligations of the parties.

10.22 **Do consultees agree that the duty of good faith should continue as an interpretative principle, but should not in itself give either party a cause of action?**

[10] Insurance Contract Law: Post Contract Duties and other Issues (2011) LCCP 201/SLCDP 152, paras 3.11 to 3.15.

[11] Article 7.

"Utmost good faith" or just "good faith"?

10.23 Finally, we seek views on whether the duty of good faith should be seen as requiring "utmost good faith" or simply "good faith".

10.24 The inclusion of the word "utmost" has been subject to considerable academic criticism. Professor Howard Bennett has shown that this was a nineteenth century addition, which was not within Lord Mansfield's original formulation.[12] Professor Lowry has queried whether the duty of good faith should be beyond honesty. He noted that section 17 does not exactly mirror the law it came to codify which distinguished between the policyholder's "deliberate concealment and misrepresentation (bad faith) and innocent (good faith) mistaken belief".[13]

10.25 Gerald Swaby and Dr Paul Richards view the modern concepts of "good faith" and "utmost good faith" as interchangeable, both representing a flexible doctrine which depends on the facts and circumstances of each case.[14] According to Lord Justice Aikens, however, the issue is unclear.[15] He cites the confusing history of the phrase and points to Lord Hobhouse's view in *The Star Sea*, that there is a difference between "good faith" and "utmost good faith".[16]

10.26 We welcome views on the issue.

10.27 **Should section 17 refer to "utmost good faith" or simply "good faith"**?

[12] Professor Howard Bennett, Mapping the doctrine of utmost good faith in insurance contract law, [1999], *Lloyd's Maritime & Commercial Law Quarterly*, Issue 2, 165.

[13] Professor John Lowry, Whither the duty of good faith in UK insurance contracts*,* [2009], *Connecticut Insurance law Journal*, Vol 16.1] 97*.*

[14] G Swaby and P Richards, Insurance reforms: rebalancing the kilter? (2011) 6 *Journal of Business Law* 535.

[15] Lord Justice Richard Aikens, The Post-contract duty of good faith in insurance contracts: is there a problem that needs a solution? (2010) 5 *Journal of Business Law* 379.

[16] *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd (The Star Sea)* [2003] AC 469 HL.

CHAPTER 2

THE LAW OF WARRANTIES

PART 11
WARRANTIES: INTRODUCTION

THE EFFECT OF A WARRANTY

11.1 A warranty is a term in an insurance contract which carries particularly harsh consequences for the policyholder. These consequences are set out in the Marine Insurance Act 1906. Section 33(3) states that a warranty "must be exactly complied with, whether material to the risk or not". If not, "the insurer is discharged from liability from the date of the breach of warranty". Furthermore, under section 34(2), once a warranty is broken, the policyholder "cannot avail himself of the defence that the breach has been remedied, and the warranty complied with, before loss".

11.2 These provisions have been held to apply to all types of insurance, not just marine insurance. Their combined effect is that if a policyholder breaches a warranty, the insurer may refuse claims for any subsequent losses. This is true even if the breach was minor, had no relevance to the loss, or had already been remedied before the loss took place.

11.3 The severe effect of breach of a warranty may be illustrated by the case of *De Hahn v Hartley*.[1] In 1779 a policy of insurance was taken out on a ship sailing from Liverpool to the British West Indies. This was a dangerous business and the policy described the vessel as having "sailed from Liverpool with 14 six-pounders, swivels, small arms and 50 hands or upwards".

11.4 The ship set sail from Liverpool with only 46 hands. It docked at Anglesey six hours later where it picked up a further six men. Off the coast of Africa the ship (still with 52 hands) was captured and lost. The insurer refused to pay and the court agreed. It was irrelevant that the breach had been remedied only six hours later and before the ship had left the relatively safe waters around Britain.

BASIS OF THE CONTRACT CLAUSES

11.5 The problems posed by warranties are exacerbated by the use of "basis of the contract clauses". If a prospective policyholder signs a statement on a proposal form stating that the answers given form the "basis of the contract", this has the effect of converting all the answers into warranties. This gives the insurer additional remedies should one of the statements be untrue. In Part 2 we saw that under section 20 of the Marine Insurance Act 1906, the insurer may only avoid the contract if a misrepresentation is "material". A basis of the contract clause goes beyond section 20, and allows the insurer to avoid liability for any inaccuracy, however unimportant.

[1] (1786) 1 TR 343. See also *Yorkshire Insurance Co v Campbell* [1917] AC 218.

11.6 The case of *Dawsons Ltd v Bonnin* demonstrates the effect of such a clause.[2] A furniture removal firm in Glasgow (Dawsons) took out insurance for one of its removal lorries. The proposal form included the following clause: "which proposal shall be the basis of this contract and be held as incorporated herein". This converted all the answers on the form into warranties. Dawsons filled out the form, and gave its business address in central Glasgow. When it was asked where the lorry would normally be parked it inadvertently wrote "above address". In fact, the lorry was usually parked in the outskirts of Glasgow.

11.7 The lorry was destroyed in a fire and Dawsons made a claim. At court, it was argued that Dawsons' mistake about the address did not add to the risk and arguably had reduced it. The court held that this did not matter: the insurance company was entitled to refuse to pay all claims under the policy.

CRITICISMS

11.8 The law of warranties has attracted criticisms for many years.[3] In 1980, the Law Commission commented that "it seemed quite wrong that an insurer should be entitled to demand strict compliance with a warranty which was immaterial to the risk".[4] Similarly, it seems unjust that an insurer should be entitled to reject a claim for any breach, "no matter how irrelevant that breach to the loss".[5]

11.9 Judges have been particularly critical of the law of basis of the contract clauses. The 1980 Report quoted judicial criticisms of such clauses dating from 1853.[6] In 1908, Lord Justice Moulton said he wished he could "adequately warn the public against such practices".[7] In 1927, Lord Wrenbury described their use as "contemptible":

> Here, upon purely technical grounds, [the insurers], 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. [8]

2 [1922] 2 AC 413; 1922 SC (HL) 156.

3 See for example, Dr Baris Soyer, Reforming Insurance Warranties – are we finally moving forward? *Reforming Marine & Commercial Insurance* Law, (2008); Sir Andrew Longmore, Good Faith and Breach of Warranty: Are we Moving Forwards or Backwards? (2004) LMCLQ 158. See also, the National Consumer Council, *Insurance Law Reform: the consumer case for review of insurance law* (May 1997). And see Kenneth Reid and Reinhard Zimmermann (eds), *A History of Private Law in Scotland* (2000), vol 2, pp 360 – 361 contributed by ADM Forte.

4 Insurance Law: Non-Disclosure and Breach of Warranty (1980) Law Com No 104, para 6.9(a).

5 Above, para 6.9(b).

6 Above, para 7.2, referring to *Anderson v Fitzgerald* (1853) 4 HL Cases 484, 10 ER 551.

7 *Joel v Law Union and Crown Insurance Co* [1908] 2 KB 863, at p 885.

8 *Glicksman v Lancashire and General Assurance Co* [1927] AC 139 at pp 144-5. See also *Mackay v London General Insurance Co Ltd* [1935] 51 Ll L Rep 201 and Lord Russell's comments in *Provincial Insurance v Morgan* [1933] AC 240 at p 250.

11.10 As we discuss in Part 12, although consumers are now protected against basis of the contract clauses, they remain a problem for business policyholders. In 1996, in *Unipac (Scotland) Ltd v Aegon Insurance Co (UK) Ltd,*[9] the Court of Session confirmed that in business insurance, where a basis of the contract clause was in place, an insurer may refuse a claim for any inaccuracy on a proposal form, including those which were immaterial.

11.11 In an international context, the UK law on warranties seems unbalanced, tending to favour the insurer over the policyholder. In the common law world, most jurisdictions have moved away from the UK approach. Although both Australia and New Zealand originally adopted statutory law equivalent to the Marine Insurance Act 1906, both have now enacted reforms.[10] In Canada, the Supreme Court has limited the effect of a breach of warranty to situations where the breach is material to the particular type of loss.[11] In the USA, insurance law is left to individual states.[12] Many states have introduced statutory reform. In Part 13 we look particularly at New York law, under which a breach of warranty will only avoid an insurance contract if it would materially increase the risk of loss.

11.12 From a civil law perspective, the idea that an insurer is discharged from liability for all risks where there has been an unconnected breach of warranty seems particularly strange. Trine-Lise Wilhelmsen, a Professor at the Scandinavian Institute of Maritime Law, commented that for most people in the civil law world, the UK concept of a warranty is "hard to understand and even harder to explain". Although the words may seem "deceptively simple", the consequences lack "logical reason" and cannot be explained in terms of either legal fairness or economic efficiency.[13] John Hare, Professor of Shipping Law at the University of Cape Town, is even more outspoken. He described the Anglo-American marine insurance warranty as "a prodigal aberration from the European *ius communis* of marine insurance".[14]

PREVIOUS PROPOSALS FOR REFORM

11.13 There have been many previous proposals for reform. In 1980, the Law Commission proposed that the insurer should be required to pay the claim if the policyholder could show that "the breach would not have increased the risk that the loss would occur in the way in which it did".[15]

[9] 1996 SLT 1197.

[10] See Part 13, para 13.3 and following.

[11] See *Century Insurance Company of Canada v Case Existological Laboratories Ltd (The Bamcell II)* [1984] 1 Western Weekly Reports 97.

[12] See *Wilburn Boat Co v Fireman's Fund* Ins 348 US 310 (1955).

[13] Duty of Disclosure, Duty of Good Faith, Alternation of Risk and Warranties: An Analysis of the Replies to the CMI Questionnaire, CMI Yearbook 2000 pp 392 and 409.

[14] John Hare, *The Omnipotent Warranty: England v The World*, paper presented at International Marine Insurance Conference, November 1999, http://web.uct.ac.za/depts/shiplaw/imic99.htm.

[15] Insurance Law: Non-Disclosure and Breach of Warranty (1980) Law Com No 104, para 6.22(b).

11.14 In 2006 we published an Issues Paper considering these matters which tentatively proposed a causal connection test.[16] These proposals were developed in our 2007 Consultation Paper, in which we distinguished between warranties of past or present fact and warranties of future conduct. For future conduct warranties, we proposed that:

> In both consumer and business insurance the policyholder should be entitled to be paid a claim if it can prove on the balance of probability that the event or circumstances constituting the breach of warranty did not contribute to the loss.[17]

11.15 In business insurance, the parties would be free to vary this rule, but we proposed controls on clauses within the insurer's standard terms.

11.16 There was considerable support for reform in this area. Many respondents agreed that the current law is "archaic", "blunt" or "unfair". There was also majority support for the idea that the insurer should only refuse a claim if it has some connection with the breach of warranty.

11.17 On the other hand, several criticisms were made of the proposals, which have led us to rethink our approach. Many thought that our proposals were too complicated, particularly in the distinction between current fact warranties and future conduct warranties. Worries were also expressed about relying on the concept of causation. As Professor Clarke warned:

> The history of English law on questions of causation is not encouraging. Two distinguished professors have written an entire book, the current edition of which runs to nearly 500 pages, on causation.

11.18 A further problem was that we had not adequately defined a warranty, as discussed below.

Problems in defining a warranty

11.19 This is a stubborn obstacle which has dogged all previous attempts to reform the law. In Part 12 we describe how warranties are an elusive target. Some cases have held that the term warranty may be applied to any term which goes to the root of the contract, whether or not it is called a warranty. In other cases, judges have attempted to protect policyholders from the harsh effects of the strict law. They have held that even if a term is called a warranty, and the contract specifies that it will have the effect of a warranty, it is not necessarily a warranty on its true construction.

[16] Issues Paper 2: Warranties (November 2006).

[17] Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured; (2007) LCCP 182/SLCDP 134 at para 12.55.

11.20 The problem is exacerbated by the fact that insurers may draft the same term in different ways - as a definition of the risk, an exclusion, or a warranty. Although the superficial effect is the same, each may lead to different consequences. For example a policyholder may "warrant" to fit and use a mortice deadlock, or the policy may exclude burglary claims unless a mortice deadlock was fitted and used at the time of the loss. These terms have different consequences:

(1) The first appears to be a warranty. If the policyholder failed to use a deadlock on one occasion, the insurer is discharged from all future liability for loss under the policy. It would not matter that the policyholder had remedied the breach, by using a deadlock at the time of the burglary. Nor would the policyholder be entitled to claim for other types of loss, such as fire damage.

(2) The second would be either a description of the risk or an exclusion. It would be construed as a "suspensive condition"; the exclusion would affect only burglary claims, not fire damage. The insurer would need to show that a mortice deadlock was not in use at the time of burglary. On the other hand, the insurer would not need to show that the lack of that lock caused the burglary. A claim could still be refused if the burglars gained entry through a window.

11.21 As we discuss in Part 12, the distinction between warranties and suspensive conditions is far from clear, and we think both should be treated alike.

OUR CURRENT PROPOSALS

11.22 Our current proposals are aimed at remedying the particular problems caused by sections 33 and 34 of the Marine Insurance Act 1906. We make three main proposals:

(1) *To abolish basis of the contract clauses*. Insurers may still use warranties of past or present fact, but they should be included specifically in the contract.

(2) *To treat warranties as suspensive conditions*. A breach of warranty would suspend the insurer's liability, rather than discharge it. Where the breach is remedied before the loss, the insurer must pay the claim.

(3) *To introduce special rules for terms designed to reduce the risk of a particular type of loss, or the risk of loss at a particular time or in a particular location*. For these terms, a breach would suspend liability in respect only of that type of loss (or a loss at that time or in that place). Thus the breach of a warranty to install a burglar alarm would suspend liability for loss caused by an intruder but not for flood loss. Similarly, a failure to employ a night watchman would suspend the insurer's liability for losses at night but not for losses during the day.

11.23 In consumer insurance, the proposed consequences of breach could not be excluded by a contract term. In business insurance, the parties would be able to contract out of these provisions, provided they did so in clear, unambiguous terms and brought the term to the attention of the other party.

THE STRUCTURE OF CHAPTER 2

11.24 This Chapter is divided into five further Parts.

(1) Part 12 explains the current law.

(2) Part 13 draws on experience in other jurisdictions. We look at how warranties are dealt with in New Zealand, Australia, Canada, the USA and Germany. We also look at the Principles of European Insurance Contract Law (PEICL).

(3) Part 14 sets out the case for reform and analyses the responses we received to our 2007 proposals.

(4) Part 15 makes proposals for reform and seeks views.

(5) Finally, Part 16 considers the proposals in relation to marine insurance and reinsurance.

PART 12
WARRANTIES: THE CURRENT LAW

HISTORY

12.1 Warranties in insurance law have an ancient pedigree. They originated in marine insurance in the Middle Ages.[1] Then, as now, policyholders were in a position of power: they knew material facts about the marine adventure and could also alter the risk once cover had been provided. It therefore became common practice for the insurer to require that the policyholder do or refrain from doing something, with severe consequences for the policyholder if the term was breached.

12.2 The general principles of insurance warranty law are founded on the rulings of Lord Mansfield, made in the late eighteenth century. His judgment in *De Hahn v Hartley,*[2] for example, laid down the rule that the validity of an insurance contract depends on the policyholder's strict compliance with the terms of a warranty. These principles were codified by the Marine Insurance Act 1906 (the 1906 Act). Some sections of the 1906 Act apply only to marine insurance, such as the implied warranties of seaworthiness and legality. Others are considered to be authoritative statements of the common law principles that apply to all insurance. In particular, the provisions which prescribe the consequence of breach of warranty apply to all insurance.[3]

WHAT IS A WARRANTY?

12.3 The term "warranty" has caused considerable confusion. In general contract law, "warranties" are considered to be relatively minor contractual terms: if breached, they only give rise to a right to damages and not a right to rescind. They are contrasted with "conditions", which are important terms that go to the heart of a contract. In insurance law, warranties mean the opposite. An insurance warranty is a particularly important contractual term which, if breached, results in the automatic discharge of the insurer's liability for loss.

The statutory definition

12.4 A partial statutory definition is provided by section 33(1) of the Marine Insurance Act 1906, which states:

> A warranty… means a promissory warranty, that is to say, a warranty by which the assured undertakes that some particular thing shall or shall not be done, or that some condition shall be fulfilled, or whereby he affirms or negatives the existence of a particular state of facts.

[1] The 12th and early 13th Centuries. See further Baris Soyer, *Warranties in Marine Insurance* (2006 2nd ed) at para 1.11 and following; J Hill, *O'May on Marine Insurance and Practice* (1993) at p 1.

[2] (1786) 1 TR 343.

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

12.5 This suggests two types of warranty: warranties of past or present fact, in which the policyholder "affirms or negatives the existence of a particular state of facts"; and warranties of future conduct, in which the policyholder undertakes "that some particular thing shall or shall not be done".

12.6 On the other hand, the inclusion of the middle category, "that some condition shall be fulfilled", seems open-ended. Many terms within an insurance contract could be said to impose a condition. The courts have struggled to decide what is or is not a warranty.

12.7 Section 35(1) of the 1906 Act states that "an express warranty may be in any form of words from which the intention to warrant is to be inferred".[4] The use of the word "warranty" is by no means decisive.[5] Merely calling something a "warranty" is not enough as the term is "always used with the greatest ambiguity in a policy".[6] In *HIH Casualty & General Insurance Co Ltd v New Hampshire Insurance Co*, Lord Justice Rix provided this guidance:

> It is a question of construction, and the presence or absence of the word "warranty" or "warranted" is not conclusive. One test is whether it is a term which goes to the root of the transaction; a second, whether it is descriptive or bears materially on the risk of loss; a third, whether damages would be an unsatisfactory or inadequate remedy. [7]

12.8 The case concerned film finance insurance, in which the original policyholder had undertaken to make six films. This was held to be a warranty, even though the word warranty was not used, because it was a fundamental term with a direct bearing on the risk.

12.9 As discussed below, in other cases, terms have been held not to be warranties, even though the word "warranty" was used, and the consequences of breach were spelled out. The courts have tried to protect policyholders against unjust consequences by interpreting the term as a "suspensive condition".[8]

CREATING A WARRANTY

Express warranties

12.10 A warranty may be either express or implied. Most warranties are created expressly by the parties. As we have seen, there is no particular form of words that confers warranty status on a term.

12.11 In marine insurance, section 35(2) of the 1906 Act states that an express warranty "must be included in, or written upon, the policy, or must be contained in some document incorporated by reference into the policy". Thus in marine insurance, an express warranty must be in writing, either in the policy or in a document referred to in the policy.

4 Marine Insurance Act 1906, s 35(1).

5 *Barnard v Faber* [1893] 1 QB 340.

6 *Roberts v Anglo Saxon Insurance Company* (1927) 2 Lloyd's Rep 550.

7 [2001] 2 Lloyd's Rep 161; [2001] EWCA Civ 735.

8 See para 12.44 and following.

12.12 This, however, applies only to marine insurance: there is no equivalent rule for non-marine insurance. In non-marine insurance, warranties have been upheld even though they are mentioned only in the proposal form.[9]

Implied warranties

12.13 In theory, warranties may be implied into a contract of insurance on the same basis as any other contract, for example for reasons of business efficacy. A leading text notes that:

> In practice this possibility is of little importance to insurance contracts. Courts have been slow to interfere in this way with the contract of insurance.[10]

12.14 It has been held that there is no implied duty on the policyholder not to do something which increases the risk during the currency of the policy. In *Baxendale v Harvey,* Pollock CB noted that *"*an insured may light as many candles as he please in his house, though each additional candle increases the danger of setting the house on fire*".*[11]

12.15 By contrast, there are statutory implied terms in marine insurance. The 1906 Act sets out four warranties to be implied into marine contracts. The most important implied warranty is that of seaworthiness.[12] Others cover portworthiness,[13] cargoworthiness,[14] and legality.[15]

12.16 The 1906 Act also implies into a marine policy six conditions which operate in the same way as warranties, in that the risk may never attach or the insurer may be discharged from liability. They relate to commencement of the risk; alteration of the port of departure; sailing for a different destination; change of voyage; deviation; and delay.[16]

[9] See *Dawsons Limited v Bonnin* [1922] 2 AC 413 and *Unipac (Scotland) Ltd v Aegon Ins Co (UK) Ltd* 1996 SLT 1197, [1999] Lloyds Rep IR 502 discussed at para 12.19 below.

[10] M A Clarke, *The Law of Insurance Contracts*, para 20-2A2.

[11] (1859) 4 H & N 445 at 449 by Pollock CB. See also M A Clarke, *The Law of Insurance Contracts*, para 20-2A2.

[12] Marine Insurance Act 1906, s 39(1) (voyage policies) and s 39(5) (time policies). For further discussion see Issues Paper 2: Warranties, Appendix A.

[13] Under s 39(2), where the policy attaches while the ship is in port, there is an implied warranty that at the commencement of the risk the ship is reasonably fit to encounter the ordinary perils of the port.

[14] Under s 40(2) of the 1906 Act in voyage policies on goods there is an implied warranty that at the commencement of the voyage the ship is reasonably fit to carry the goods to the contemplated destination.

[15] See s 41 of the 1906 Act.

[16] See the 1906 Act, ss 40(2), 41, 42, 43, 54, 46, 48 and 49 respectively.

"Basis of the contract" clauses

12.17 Warranties can also be created through "basis of the contract" clauses. This is a legal device that converts the policyholder's answers and declarations into contractual warranties. Typically, the proposer is asked to sign a statement on a proposal form that their answers form the "basis of the contract". The effect of doing so can have severe consequences for the proposer who may have answered in good faith.[17]

12.18 Basis of the contract clauses have been described as "traps", as they allow the insurer to refuse claims on the basis of minor and irrelevant mistakes.[18] As discussed in Part 2, section 20 of the Marine Insurance Act 1906 permits the insurer to avoid a policy if any statements on the proposal form are untrue, but it contains various safeguards. In particular, the misrepresentation must be "material". It must be sufficiently significant to influence the judgment of a prudent underwriter, and must have induced the insurer to enter the contract on those terms.[19] Where an insurer uses a basis of the contract clause, however, it is discharged from all liability for all mistakes, however immaterial.

12.19 For example, in *Unipac (Scotland) Ltd v Aegon Insurance Co (UK) Ltd*[20] the proposal form included a declaration that the answers were true and complete and would form the basis of the insurance contract. The policyholder made two minor errors.[21] When the insurer refused a claim for fire damage, the policyholder argued that it had answered truthfully to the best of its knowledge and belief. The Court of Session held that this was irrelevant: the wording of the clause relied on by the insurer was clear and the importance of freedom of contract was paramount. The result was "simply a consequence of what parties have agreed to by contract and parties are free to agree what they like".[22]

12.20 As discussed below, basis of the contract clauses have now been abolished in respect of consumer insurance, but they are still permitted in business insurance.

[17] See *Dawsons Ltd v Bonnin* [1922] 2 AC 413, 1922 SC (HL) 156. Basis of the contract clauses have been the subject of criticism by commentators and judges which we examined more fully in Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of warranty by the Insured; (2007) LCCP 182/SLCDP 134 at para 4.219 and following and 5.112 and following.

[18] *Zurich General Accident & Liability Insurance Co v Morrison* [1942] 2 KB 53, 58 by Lord Greene MR. Basis of the contract clauses have been the subject of criticism by commentators and judges which we examined more fully more fully in our 2007 Consultation Paper, see Law Commission Consultation Paper No 182; Scottish Law Commission Discussion Paper 134, para 4.219 and following and 5.112 and following.

[19] S 20(3) and see *Pan Atlantic Co Ltd v Pine Top Insurance Co Ltd* [1995] 1 AC 501.

[20] 1996 SLT 1197, [1999] Lloyds Rep IR 502.

[21] The proposer answered that it had been in business for a year and solely occupied its premises when in fact it had been incorporated for less than a year and shared occupation.

[22] *Unipac (Scotland) Ltd v Aegon Insurance Co (UK) Ltd* 1996 SLT 1197 at 1202, [1999] Lloyds Rep IR 502. Lord Justice Clerk Ross delivered the opinion of the court.

THE EFFECT OF A WARRANTY

Exact compliance

12.21 Section 33(3) of the 1906 Act states that a warranty "must be exactly complied with, whether it be material to the risk or not".

12.22 This means that if a policyholder has warranted that certain facts are true when they are not, the warranty will be broken even if the facts are immaterial. The issue may have no bearing on the risk, or the mistake may even give the impression that the risk is greater than it is. In *Allen v Universal Automobile Insurance Co Ltd* a car owner was found to be in breach of a warranty that £285 had been paid for the car when a reduced price £271 had been paid.[23] Similarly, in *Abbott v Shawmut Mutual* a policyholder who warranted that the property was subject to a mortgage of £6,600 was found to be in breach because the figure was in fact £6,684.[24]

12.23 Exact compliance means exactly that: substantial compliance will not do. On the other hand, an insurer cannot demand any greater performance. A warranty that a ship has 20 guns does not additionally require that there is sufficient crew to man them.[25]

Automatic discharge from liability

12.24 The 1906 Act provides that if a warranty is not complied with, the insurer is discharged from liability from the time of breach: the insurer is not liable for any claims arising after that event. Section 33(3) states:

> … subject to any express provision in the policy, the insurer is discharged from liability as from the date of the breach of warranty, but without prejudice to any liability incurred by him before that date.

12.25 For the policyholder, the consequences of breaching a warranty are severe because of the function a warranty fulfils. As Lord Goff explained in *The Good Luck*:

> … if a promissory warranty is not complied with, the insurer is discharged from liability as from the date of the breach of warranty, for the simple reason that fulfilment of the warranty is a condition precedent to the liability of the insurer. This, moreover, reflects the fact that the rationale of warranties in insurance law is that the insurer only accepts the risk provided that the warranty is fulfilled. This is entirely understandable; and it follows that the immediate effect of a breach of promissory warranty is to discharge the insurer from liability as from the date of the breach.[26]

[23] (1933) 45 Ll L Rep 55.

[24] 85 Mass 213 (1861).

[25] *Hide v Bruce* (1783) 3 Doug K B 213.

[26] *Bank of Nova Scotia v Hellenic Mutual War Risks Association (Bermuda) Ltd* [1991] 2 WLR 1279; [1992] 1 AC 233 at 262.

12.26 Lord Goff further explained that although the insurer is discharged from liability from the date of breach, the policyholder's obligations, for example a continuing liability to pay a premium, survive after this point.[27]

12.27 As the discharge of the insurer's liability is automatic neither party to the insurance need take any step in relation to it. As Professor Clarke explains, "the former policyholder is suddenly without cover and often quite unaware of it".[28] The Association of British Insurers (ABI), in their response, noted that this consequence can be "highly problematic for an insured". The policyholder does not realise that it must either negotiate with the insurer to restore cover or take steps to find alternative cover.

12.28 The loss of insurance cover may also have serious consequences for third parties, such as assignees or mortgagees. They may be left without cover even if they did not cause or contribute to the breach.[29]

Breach not material to risk or loss

12.29 Breach of a single warranty discharges liability for all risks covered by the policy. In strict law, breach of a warranty which is associated with one risk, such as fire, will also discharge the insurer from liability for losses of some other kind, such as flood.[30]

12.30 For example, in *Dawsons Ltd v Bonnin*, the insurers were allowed to treat the policy as terminated by the breach of warranty even though the misrepresented fact was not material to the risk and was irrelevant to the type of loss which occurred.[31]

Later remedy irrelevant

12.31 The harshness of the current law is compounded by the fact that even if the policyholder remedies the breach this does not restore cover. Section 34(2) of the 1906 Act prevents this:

> Where a warranty is broken, the assured cannot avail himself of the defence that the breach has been remedied, and the warranty complied with, before loss.

So if the policyholder has warranted to service a burglar alarm within one week, but does not do so for two weeks, the insurer's liability is discharged after one week. The later remedial action does not restore cover.[32]

[27] See *Bank of Nova Scotia v Hellenic Mutual War Risks Association (Bermuda) Ltd*, *(The Good Luck)* [1992] 1 AC 233, by Lord Goff at 263.

[28] M A Clarke, Insurance Warranties: The Absolute End? 2007 *LMCLQ* 474.

[29] *Scottish Equitable Life Assurance Society v Buist & Ors* (1877) 4 R 1076.

[30] This is the effect of the 1906 Act, s 33(3).

[31] [1922] 2 AC 413; 1922 SC (HL) 156. In this case the warranty was created by a "basis of the contract" clause.

[32] Subject to the insurer's right to waive the breach, for which see para {12.36 and following.}

12.32 The case of *De Hahn v Hartley* provides a vivid example.[33] The fact that the ship left Liverpool with only 46 hands broke the warranty that there should be "50 hands or upwards" on board.[34] The insurer was discharged from liability from that point. It was irrelevant that the breach was remedied when the ship picked up a further six men in Anglesey six hours later.

Payment of premium warranties

12.33 The effect of section 34(2) of the 1906 Act is even starker in the case of payment of premium warranties. An insurance contract may contain a warranty that the policyholder will pay the premium, or an instalment of the premium at a specified time or rate, or within so many days of it falling due. The insurer's liability for loss will be discharged if the terms of the warranty are not strictly complied with, even where payment is no more than one or two days late.

12.34 Although the policyholder may pay the outstanding instalment and so remedy the breach, they are left without cover. The policyholder also may be surprised to learn that in addition to this, they remain liable to pay each future instalment as and when it falls due.[35]

"Subject to any express provision"

12.35 Section 33(3) of the 1906 Act is subject to any express terms of the contract. It therefore represents the default position: the parties can contract out of automatic termination. Where there is an express provision, the effect can be that it "waters down" section 33 by restricting the circumstances in which a warranty will bite.[36]

EXCUSED NON-COMPLIANCE AND WAIVER

12.36 The 1906 Act provides two instances where the breach of a warranty does not end the insurer's liability for loss. First, section 34(1) provides that non-compliance is excused in circumstances where, by change of circumstances, the warranty ceases to be applicable or when compliance is rendered unlawful by subsequent law.

12.37 Secondly, section 34(3) gives the insurer the power to waive a breach of warranty. It states that "a breach of warranty may be waived by the insurer".[37] This is regardless of the automatic discharge of the insurer's liability under section 33(3).

[33] See Part 11, para 11.3 for the facts.

[34] (1786) 1 TR 343.

[35] *Chapman v Kadirga Denizcilik ve Ticaret* [1999] Lloyd's Rep IR 377.

[36] *Printpak v AGF Insurance Ltd* [1999] 1 All E R (Comm) 466 by Hirst LJ.

[37] See the 1906 Act, s 34(3).

12.38 There is considerable academic debate about how liability which has ceased to exist can be resurrected by waiver.[38] Professor Clarke explained the contradiction thus:

> The contract is dead but the insurer can still waive it back to life.[39]

12.39 In English contract law, there are two ways in which a party may be taken to have waived its rights when faced with the other party's repudiatory breach.[40] The first way is waiver by election. The party who has the choice may either accept the repudiation or affirm the continued existence of the contract.[41] Once the party has made the choice to affirm the contract, it is bound by that decision.

12.40 Following *The Good Luck*, it appears that waiver by election does not apply to breach of an insurance warranty. The reasoning of the Court was that because breach of warranty automatically discharges the insurer from liability the insurer has no election to make. This view was confirmed by the Court of Appeal in *Kosmar Villa Holidays Plc v Trustees of Syndicate 1243.*[42]

12.41 The second form of waiver is "waiver by estoppel". The leading case explains that this is "a promise not to rely upon a defence … or a right".[43] It requires a representation, in words or conduct, which must be unequivocal, and which must have been relied upon in circumstances "where it would be inequitable for the promise to be withdrawn".[44]

12.42 This puts a heavier burden on policyholders. They not only have to show that the insurer made an unequivocal representation, but also that they relied on it. As it is an equitable remedy, it is entirely discretionary and subject to the usual equitable defences. The outcome of any particular case can be hard to predict.

[38] See Baris Soyer, *Warranties in Marine Insurance* (2nd ed 2006) at ch 6; M A Clarke, *The Law of Insurance Contracts* (4th ed 2002) para 20-7A; and Legh-Jones, Birds and Owen, *MacGillivray on Insurance Law* (11th ed 2008) para 10-104.

[39] M A Clarke, Insurance Warranties: The absolute end? *LMCLQ* 2007 474.

[40] For a full discussion of the authorities on this point see *Peyman v Lanjani* [1985] 1 Ch 457. In *Habib Bank Ltd v Tufail* [2006] EWCA Civ 374, [2006] All ER (D) 92 (Apr) Lloyd LJ drew a distinction between affirmation, "where knowledge of the right to rescind is essential" (at [20]) and "acquiescence", which requires the other party to show that it relied on the representation.

[41] See *Chitty on Contracts* (30th ed 2011) para 24-002.

[42] [2008] EWCA Civ 147 at [68] and [70].

[43] *Kosmar Villa Holidays Plc v Trustees of Syndicate 1243* [2008] EWCA Civ 147 at [38].

[44] Above at [82].

12.43 Scots law does not draw a distinction between waiver by election and waiver by estoppel equivalent to that in English law.[45] The decision of the House of Lords in *Armia Ltd v Daejan Developments Ltd* is the leading authority.[46] It held that a party relying on the other party's abandonment of a right must demonstrate that it has conducted its affairs on the basis of the waiver − but it need not go so far as to show that it has suffered prejudice as a consequence of relying upon it.[47] In reaching this decision, the House of Lords referred to certain English authorities, while cautioning that the Scots law of personal bar should not be assumed to be the same as the English law of estoppel.

MODERATING HARSH LAW THROUGH STRICT INTERPRETATION

12.44 For many years, the courts had attempted to moderate the harshness of the law. It is well-established that warranties should be construed strictly, against the interest of the party who has put them forward. Terms which appear to be warranties may also be construed as "suspensive conditions", which apply only for the duration of the breach.

12.45 The leading case is *Provincial Insurance Company Ltd v Morgan & Foxton*.[48] Coal merchants declared that their lorry would be used for coal, which became the basis of the contract. On the day of the accident, the lorry had also been used to carry Forestry Commission timber, but at the time of the accident only coal was on board. The House of Lords held that on "a strict but reasonable construction" the clause only meant that transporting coal was to be the normal use. Transporting other goods would not terminate liability under the policy.[49]

Principles of interpretation

12.46 The courts have developed several principles of interpretation which can be used to mitigate the harsh effects of a warranty.[50] These include:

(1) An ambiguous warranty will be construed against the insurer.[51]

(2) If the underwriters wish a warranty to have draconian consequences, they must stipulate for them in clear terms.[52]

(3) The draconian effect of a warranty is relevant to considering whether literal words are consistent with a reasonable and businesslike interpretation.[53]

[45] See Reid & Blackie, *Personal Bar* (2006), paras 3-12 – 3-16 and 3-40 – 3-41.

[46] 1979 SC (HL) 56.

[47] Above at 68-69 by Lord Fraser of Tullybelton and 71-72 by Lord Keith of Kinkel. See also *Moodiesburn House Hotel Ltd v Norwich Union Assurance Ltd* 2002 SLT 1069.

[48] [1933] AC 240.

[49] See also *English v Western* [1940] 2 KB 156 and *Houghton v Trafalgar Insurance Co Ltd* [1954] 1QB 247.

[50] See also Issues Paper 2: Warranties, Part 4 at para 4.4 and following.

[51] *Pratt v Aigion Insurance Company SA (The Resolute)* [2008] EWCA Civ 1314 at [14], [2009] 2 All E.R. (Comm) 387.

[52] *AC Ward & Sons Ltd v Catlin (Five) Ltd* [2009] EWCA Civ 1098 at [28].

(4) The more unreasonable the result, the more unlikely it is that the parties can have intended it, and if they do intend it the more necessary it is that they should make the meaning clear.[54]

(5) The warranty may be construed as being relevant to only some risks covered in the policy.[55]

(6) A literal interpretation of a warranty must not be inconsistent with other terms in the policy.[56]

(7) The term may be found not to be a warranty but some other contractual term, such as one descriptive of the risk.[57]

Contrasting case law

12.47 How a court approaches the task of interpreting a term that appears to be a warranty may vary widely, as can be seen in the two cases we discuss next.

Kler Knitwear

12.48 A striking example where an apparent warranty was found not be a warranty is *Kler Knitwear v Lombard General Insurance Co Ltd.*[58] The policyholders were subject to a term that their sprinkler system would be inspected 30 days after renewal. The contract stated that the term was a warranty and specified that non-compliance would bar any claim "whether it increases the risk or not". In fact, the inspection was about 60 days late and showed that the system was working. The factory later suffered storm damage (which was wholly unconnected with the sprinklers).

12.49 Mr Justice Morland accepted in principle that if, on a proper construction of the clause, the parties intended it to be a warranty then the court "must uphold that intention", however harsh and unfair the consequences. However, this particular clause was merely "a suspensive condition" limiting the risk. It applied only during the 60 days when the policyholder had failed to inspect the sprinkler system.

12.50 The case is difficult because on its facts it appears that the parties did intend the term to be a warranty. One commentator noted that:

[53] *AC Ward & Sons v Catlin (Five) & Ors* [2008] EWHC 3585 (Comm) at [29].

[54] *Wickman Machine Tools Sales Ltd v Shuler AG* [1974] AC 2325, cited in *AC Ward & Sons v Catlin (Five) & ors* [2009] EWCA Civ 1098 at [29].

[55] *Printpak v AGF Insurance Ltd* [1999] Lloyd's Rep IR 542.

[56] *AC Ward & Son Ltd v Catlin (Five) Ltd* [2009] EWHC 3122 (Comm).

[57] *Farr v Motor Traders Mutual Insurance* [1920] 3 KB 669, where the term that a taxi was to be driven for only one shift a day was held to be descriptive of the risk and cover was suspended when it was used for two shifts a day. The case was approved in *Provincial Insurance v Morgan* [1933] AC 240.

[58] [2000] Lloyd's Rep IR 47.

> It is difficult to see how the insurer could have stipulated this in any clearer terms. The term itself was called a warranty and was drafted in clear and intelligible language and the consequences of non-compliance were spelled out.[59]

Sugar Hut

12.51 In the more recent case of *Sugar Hut v Great Lakes Reinsurance (UK) Plc*, the court took a different approach.[60] The claimants insured four nightclubs. When the Brentwood club suffered fire damage, the insurers refused the claims on various grounds. The judge found that the insurers were entitled to refuse cover for multiple reasons, including several non-disclosures and breaches of warranty. The judge considered the decision in *Kler Knitwear* but held that in this case several terms were in fact "true warranties" rather than suspensive conditions.

12.52 In particular, one term obliged the policyholders to install a burglar alarm that rang through to a central monitoring station. The court found that the alarm was inadequate as it only contacted a Sugar Hut employee. Mr Justice Burton held that this alone would be sufficient to absolve the insurers from liability under the contract. The term:

> was significantly material to the risk of loss; and it does not influence such conclusion … that in the event the absence of such burglar alarm was not in any way causative of the loss suffered by the fire.[61]

12.53 The judge heard evidence that the insurers had extended the deadline for upgrading the alarm, which suggested that the term was treated as a suspensive condition. The judge found, however, that this made no difference. In *Kler Knitwear*, the sprinkler requirement was complied with before the storm damage. Here the upgrade work was never carried out. As the defendants remained in breach, liability for all risks was suspended at the time of the fire.

12.54 As we discuss in Part 13, very few legal systems would consider it just to permit an insurer to refuse a claim for fire damage because the wrong sort of burglar alarm was installed. In Part 15 we return to this case and show how a different approach would be taken under our proposed reforms.

The result: inconsistencies of interpretation

12.55 There is no doubt that the courts have used interpretative principles to evade the harshness of the law and do justice in individual cases. The problem is that where the outcome of a case is dependent on the courts' interpretation, inconsistencies creep in.

[59] *Bird's Modern Insurance Law*, (8th ed 2010), para 9.8.

[60] [2010] EWHC 2636.

[61] Above at [49].

12.56 Two cases illustrate the point. *The Newfoundland Explorer* and *The Resolute* both turned on similarly worded contract terms.[62] In *The Newfoundland Explorer* a yacht owner warranted that the vessel would be "fully crewed at all times", while in *The Resolute* the owner warranted that the owner, or the skipper in charge and one crew member, would be on board "at all times".

12.57 In each case the damage occurred while the vessels were either berthed or safely tied up, without crew on board. Both insurers rejected the policyholder's claim and this decision was challenged. The challenge failed in *The Newfoundland Explorer* but succeeded in *The Resolute*.

12.58 In *The Newfoundland Explorer*, the court interpreted the warranty literally and found that "at all times" "means what it says – the whole time, not some of the time". In *The Resolute* the Court of Appeal held that the warranty should be given a reasonable and businesslike interpretation in the light of its context and purpose.[63] It followed from this that the principal time when the vessel should be crewed was when it was being navigated.

12.59 We have been told that the courts' approach to construction discourages insurers from taking purely technical points, or attempting to use warranties in a wholly unreasonable way. While this has advantages it also introduces uncertainty into the law.

WARRANTIES IN CONSUMER INSURANCE: OTHER PROTECTIONS

12.60 For consumers there are other statutory and regulatory safeguards. These include Financial Services Authority rules, the Unfair Terms in Consumer Contracts Regulations 1999 (UTCCRs), and the Consumer Insurance (Disclosure and Representations) Act 2012.

12.61 Furthermore, the Financial Ombudsman Service is not bound by the strict letter of the law, and has jurisdiction to hear complaints from consumers and micro-businesses. Below we consider these additional protections.

Financial Services Authority (FSA) rules

12.62 For many years, the insurance industry has accepted that the rules set out in the Marine Insurance Act 1906 are unsuitable for consumer insurance. In 1977, the British Insurance Association and Lloyds agreed a Statement of General Insurance Practice to moderate the effects of law. In 1986, this was updated and strengthened to state that:

> An insurer will not repudiate liability to indemnify a policyholder
>
> > On the grounds of a breach of warranty or condition where the circumstances of the loss are unconnected with the breach unless fraud is involved.

[62] *GE Frankona Reinsurance Ltd v CMM Trust No 1400 (The Newfoundland Explorer)* [2006] EWHC 429; *Pratt v Aigion Insurance (The Resolute)* [2008] EWCA Civ 1314.

[63] A "shift" in the approach of the courts to the construction of contractual terms noted by Lord Steyn in *Sirius Insurance Co Ltd v FAI Insurance Ltd* [2004] UKHL 54, [2004] 1 WLR 3251.

12.63 When the Financial Services Authority was established in 2001, this voluntary statement was incorporated into the FSA Handbook. The Handbook was revised in 2007. The provision now appears at ICOBS 8.1.2. in the following terms:

> … rejection of a consumer policyholder's claim is unreasonable, except where there is evidence of fraud, if it is for:
>
> […]
>
> (3) breach of warranty or condition unless the circumstances of the claim are connected to the breach.[64]

12.64 The reference to "evidence of fraud" has proved controversial. In 1980, the Law Commission commented that this "in effect confers a discretion on insurers to repudiate a policy on technical grounds if they suspect fraud but are unable to prove it".[65]

12.65 FSA rules cannot be applied in court. Courts continue to be bound by the Marine Insurance Act 1906. Instead, FSA rules apply only in a regulatory context. In theory, in the case of repeated breaches, the FSA may bring disciplinary action against the insurer, leading to fines or (ultimately) withdrawal of authorisation. It is also possible for a consumer to bring an action for breach of statutory duty, though this is neither simple nor straightforward. In practice, we are not aware that any action has ever been brought by either the FSA or consumers as a result of a breach of FSA rules on warranties.

12.66 The main effect of the FSA rules are that it is used as a guiding principle in Ombudsman decisions. As we explore below, it is common for Ombudsmen to prevent insurers from rejecting claims for issues which are not connected to the loss.

Unfair terms in consumer contracts

12.67 Insurance is excluded from the effect of the Unfair Contract Terms Act 1977. However, consumer insurance contracts are covered by the Unfair Terms in Consumer Contracts Regulations (UTCCR) 1999.[66] The Regulations implement the EU Directive on Unfair Terms in Consumer Contracts 1993.[67] They allow a court to review the fairness of all non-negotiated terms, unless the term falls within the exemption set out in Regulation 6(2).

[64] The rule provides an exception in insurance on the life of another: here warranties may be used to give representations by the life insured the same status as representations by the policyholder. The use of warranties in these circumstances has been superseded by section 7 of the Consumer Insurance (Disclosure and Representations) Act 2012, which provides for the same effect.

[65] Insurance Law: Non-Disclosure and Breach of Warranty, (1980) Law Com No 104, para 6.10.

[66] SI 1999 No 2083.

[67] Council Directive 93/13/EEC of 5 April 1993.

12.68 Regulation 6(2) prevents a court from assessing "the definition of the main subject matter of the contract" or "the adequacy of the price", provided the term is in plain intelligible language. There is considerable debate about what this means.

12.69 In the first Consultation Paper we considered at length whether a warranty could be considered to be the "main definition of the subject matter". The preamble to the EU Directive states that, "the terms which clearly define or circumscribe the insured risk and the insurer's liability shall not be subject to such assessment since these restrictions are taken into account in calculating the premium paid by the consumer".[68] This has led some commentators to argue that all terms which circumscribe the risk may not be reviewed for fairness.[69] In 2007 we highlighted that the term must be clear: we thought that a warranty would only be exempt from review if it had been highlighted to the consumer before the contract was formed. We acknowledged, however, that the issue was far from clear.

12.70 Since 2007, the issue of which terms are exempt from review has generated further litigation. In *Office of Fair Trading v Abbey National plc,* the Supreme Court rejected that idea that only central or "core" terms were exempt. It held that all price terms were exempt if the assessment related to the amount of the price in proportion to the goods or services supplied.[70] This leaves some confusion about what amounts to the "definition of the main subject matter".[71]

12.71 It is possible that in consumer insurance contracts the courts could mitigate the harshness of the law by holding that a term with draconian consequences was unfair within the meaning of the Unfair Terms in Consumer Contracts Regulations 1999. The argument, however, is a difficult one for a consumer to make, and is likely to lead to complex litigation. The existence of the Unfair Terms in Consumer Contracts Regulations 1999 does not remove the need to reform the law of warranties.

[68] Recital 19. Although the 1999 Regulations do not contain a similar statement the definition of core terms will be construed according to the Directive.

[69] See M A Clarke, *The Law of Insurance Contracts*, para 19-5A3. See also Legh-Jones, Birds and Owen, *MacGillivray on Insurance Law*, (11ed 2008), para 11-36.

[70] [2009] UKSC 6, [2010] 1 A C 696.

[71] For example *Office of Fair Trading v Ashbourne Management Services* [2011] EWHC 1237 (Ch) considered whether a term which required customers to remain members of the gym for a minimum period was "the main subject matter of the contract". The court found that it was, but that it could still be assessed for review. This is because the assessment related to the consequences of the term rather than its "definition". This is a complex argument which is not always easy to follow.

The Consumer Insurance (Disclosure and Representations) Act 2012

12.72 The law on non-disclosure and misrepresentation in consumer insurance has been reformed by the Consumer Insurance (Disclosure and Representations) Act 2012 which received Royal Assent on 8 March 2012.[72] The Act gives effect to the recommendations made by the Law Commissions in our joint Report on *Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation*.[73]

12.73 The 2012 Act is directed at pre-contract information: it governs what a consumer must tell an insurer before taking out insurance. It does not deal with warranties as such. The Act does, however, prevent insurers from using basis of the contract clauses in consumer insurance contracts.

12.74 Section 6 deals with representations made by consumers in connection with a proposed consumer insurance contract or variation. Section 6(2) states that:

> Such a representation is not capable of being converted into a warranty by means of any provision of the consumer insurance contract (or the terms of a variation), or of any other contract (and whether by declaring the representation to form the basis of the contract or otherwise).

12.75 The section is limited in scope. It remains possible for insurers to include specific warranties within their policies. These warranties *may* deal with issues that are also covered by questions on the proposal form. The insurer may not, however, use a contract term or other device to convert representations into warranties.

The Financial Ombudsman Service (FOS)

12.76 The FOS hears complaints from consumers and "micro-businesses" (defined as businesses which employ fewer than 10 staff and have an annual turnover of less than €2 million). The FOS has a general discretion to decide cases according to what is fair and reasonable. In practice, dissatisfied consumers may be more likely to take a case to the FOS than to court.[74]

12.77 In 2006, the Law Commissions carried out a study to gain a better understanding of the FOS approach to warranties. We read 50 final ombudsman decisions concerning consumer policy terms, and a further 18 cases concerning terms in small business cases.[75]

12.78 We found that it was rare for insurers to insist on the strict application of the law on warranties in consumer cases. Although a few exclusions appeared to be written in wide terms, no insurer argued that they should be discharged from liability by an immaterial breach, or where the breach had already been remedied.

[72] 2012 c 6.

[73] LCCP 319/SLCDP 219.

[74] For further discussion see LCCP 182/SLCDP 134, Part 7 at para 7.25 and following.

[75] See Issues Paper 2: Warranties, Appendix B.

12.79 However, issues of causal connection can arise for exclusion terms as well as for warranties. In some cases, the FOS overturned an insurer's decision to reject a claim where the breach the insurer relied on did not cause the loss in question. In one case, for example, the complainant claimed for a stolen bicycle, but the firm rejected the claim because at the time of the theft it was not locked to a secure structure. The complainant argued that this would not have made any difference: many bicycles were stolen at the same time, including locked bicycles. The ombudsman ordered the firm to pay the claim.

12.80 Warranties were more common in small business contracts. Examples included a Chinese restaurant subject to a warranty that the wok should never be left unattended; and a pub subject to warranties over how the deep fat frying range should be cleaned.

12.81 We did not find any cases in which an insurer had attempted to refuse a claim solely because of a breach of warranty that had no connection with the claim. However, insurers might raise secondary issues about such breaches. Generally, the FOS gave short shrift to technical defences which had no connection to the claim.

CONCLUSION

12.82 The strict law of warranties, as set out in the Marine Insurance Act 1906, is extremely harsh. A breach of warranty automatically discharges an insurer from liability from the time of the breach, even if the warranty has no bearing on the risk. Once a warranty has been breached, the insurer may reject all claims, even for losses which occur after the breach has been remedied.

12.83 In business insurance, the courts have found various ways to mitigate these draconian consequences. They may interpret the warranty strictly, against the interests of the insurer; they may hold that a warranty applies only to some risks and not others; or they may find that a term which appears to all intents and purposes to be a warranty is only a suspensive condition. This, however, has led to uncertainty and complexity in the law. It is not at all clear when a term is a warranty. It also makes the law of the UK appear unfair and unprincipled in the international market.

12.84 In consumer insurance, insurers appear to have accepted that a breach of warranty should not discharge an insurer from liability for claims unconnected to the breach. This rule originated in industry statements of practice, and now appears in the FSA handbook. It is upheld by the FOS. This leads to a disjuncture between the law as set out in statute and the law applied in practice.

PART 13
WARRANTIES: COMPARATIVE LAW

13.1 As we have seen, under the Marine Insurance Act 1906, breach of a warranty has harsh consequences for the policyholder. These consequences are unique to the common law. Most civil law systems require that a breach is connected in some manner either to the risk or to the loss before an insurer is absolved from payment.[1] English law was, however, exported to many common law countries, which originally had insurance codes modelled on the 1906 Act. Most have now reformed their laws.

13.2 Here we look briefly at the changes made in New Zealand, Australia, Canada and the USA to see what lessons they might hold for reform.[2] We also provide a brief indication of the civil law approach by looking at the law in Germany and under the Principles of European Insurance Contract Law (PEICL).[3]

NEW ZEALAND

13.3 In New Zealand the relevant provision is section 11 of the Insurance Law Reform Act 1977 (the 1977 Act). This covers not just warranties but also other terms which have a similar function. It applies to policy terms that meet two tests:

(1) The term must exclude or limit the liability of the insurer on the happening of certain events or the existence of certain circumstances; and

(2) the reason for the term is because, in the view of the insurer, the circumstances or events are likely to increase the risk of such loss occurring.

13.4 Where a term falls within this definition, the policyholder is entitled to be paid the claim if it proves that the loss was not caused or contributed to by the events or circumstances in question.

13.5 In 1998 the New Zealand Law Reform Commission (NZLRC) reviewed section 11.[4] They expressed concern that the courts had interpreted the section to impose liability on insurers even if the policyholder was in blatant breach of a term delimiting the risk.[5] They thought that a causal connection test should not apply to a provision which:

1 For a comparison between the English, German and Norwegian approach to breach of warranty in marine insurance, see Baris Soyer, *Warranties in Marine Insurance* (2nd ed, 2006). He states that in both Germany and Norway provisions exist to exempt the insurer from liability if the nature of the risk changes during the life of the policy. However, unlike the English law, these require some degree of culpability and causation.

2 See also Issues Paper 2: Warranties (November 2006), Part 6 and Insurance Contract Law: Misrepresentation, Non-disclosure and Breach of Warranty; (2007) LCCP 182/ SLCDP 134, Part 7, para 7.52 and following.

3 See also Part 3, para 3.27 and following.

4 *Some problems of insurance law* (1998) NZLRC No 46, Ch1.

5 *New Zealand Insurance Co Ltd v Harris* [1990] 1 NZLR 10; *State Insurance Ltd v Lam* 1996, unreported.

(1) defines the age, identity, qualifications or experience of a driver of a vehicle, a pilot of an aircraft, or an operator of a chattel; or

(2) defines the geographical area in which a loss must occur if the insurer is to be liable to indemnify the insured; or

(3) excludes loss that occurs while a vehicle, aircraft or other chattel is being used for commercial purposes other than those permitted by the contract of insurance.

13.6 The New Zealand Law Reform Commission considered following the Australian model (discussed next), but rejected this approach as they thought that it would give rise to uncertainty.

13.7 The exact scope of section 11 of the 1977 Act is still a live issue. The recent case of *Nelson Forests Ltd v Tree Tuis Ltd* suggests that it may be more limited than once thought.[6] Here the insurance contract covered business liability for a farming operation. In addition to farming, the policyholder, Mr Garnett, rented out tourist cabins. A forest fire was started when embers from the grate of one of the cabins were disposed of in woodland without being properly extinguished.

13.8 Mr Garnett's claim to be indemnified was refused on the basis that it did not arise in the course of his farming operations. Mr Garnett argued that section 11 applied because the term which confined coverage to farm operations "excluded or limited the insurer's liability". This argument was rejected on the ground that the term did not limit existing cover but instead defined the risk the insurer had agreed to cover from the outset. The policyholder's tourism operation was never within the risk covered and the section was not engaged.

13.9 The New Zealand experience illustrates the difficulties of distinguishing between terms which define the risk, and those which limit liability in defined circumstances. A causal connection test which is suitable for specific warranties about locks, alarms or sprinklers may not be suitable for terms which define the nature of the business or the geographical limits of the policy.

AUSTRALIA

13.10 In Australia, general insurance law was reformed by the Insurance Contracts Act 1984 (the 1984 Act), although the Act does not apply to marine insurance or reinsurance.[7] The relevant provision is section 54, which has a wide application. It applies to any term that excludes or restricts cover by reason of an act or omission of the insured.

[6] Civ- 2010-442-84 (9 December 2010). The judgment was upheld in the New Zealand Court of Appeal although the section 11 point was no longer in issue; see *Garnett v Tower Insurance and ors* COA CA4/2011 [15 November 2011].

[7] Nor does it apply to workers' compensation, export credits and some compulsory third party car insurance contracts.

13.11 The section distinguishes between acts capable of causing loss and acts not capable of causing loss. Section 54(2) of the 1984 Act provides that where the insured's act could reasonably be regarded as being capable of causing or contributing to the loss, the insurer may refuse to pay the claim. This however is subject to two rights for the insured:

(1) Where the insured proves that no part of the loss giving rise to the claim was caused by its act, the insurer may not refuse to pay the claim by reason only of the act.[8]

(2) Where the insured proves that some part of the loss was not caused by the act, the insurer may not refuse to pay that part of the loss.[9]

13.12 Section 54(6) of the 1984 Act states that an "act" includes an "omission", which extends the potential scope of the provisions.

13.13 Where the act or omission is not capable of causing or contributing to a loss, section 54(1) allows the insurer to reduce its liability "by the amount that fairly represents the extent to which … [its] interests were prejudiced".

13.14 Section 54 of the 1984 Act is a complex provision, which has proved difficult to interpret. In 2001 the Australian Law Reform Commission noted that the "question concerning categories of act or omission covered by Section 54 has been a matter of some legal controversy".[10] Their report was published before the Australian High Court decision in *FAI v Australian Hospital Care Pty Ltd*, in which the majority endorsed a very liberal construction of the section in relation to "claims made and notified" policies.[11] To the alarm of the insurance industry, the court held that the policyholder's failure to notify a claim within the period specified in the contract fell within the ambit of 54(1). The policyholder was therefore entitled to be paid the claim, less an amount which fairly represented the prejudice suffered by the insurer.[12]

13.15 Section 54 of the 1984 Act has supporters. In 2003 a Commonwealth Treasury Review of the section thought that the problems were confined to "claims made" and "claims made and notified" policies. It found that the section worked satisfactorily in the vast majority of occurrence insurance, and "the prominent message from meetings and submissions is that the operation of section 54 in relation to 'occurrence' policies should remain unchanged".[13]

[8] Section 54(3).

[9] Section 54(4).

[10] ALRC Report 91 (2001).

[11] [2001] HCA 38.

[12] For further discussion see Issues Paper 2, paras 6.25 to 6.41 and see R Merkin, *Reforming insurance law: is there a case for reverse transportation?* Report for the English and Scottish Law Commissions on the Australian experience of insurance law reform (2007).

[13] A Cameron and N Milne, *Review of the Insurance Contracts Act 1984: Report into the Operation of Section 54* (2003), Commonwealth of Australia, p 9.

13.16 On the other hand, Professor Baris Soyer noted that section 54 had generated "a good deal of litigation over the years".[14] In addition to dealing with questions of causation, the courts were expected to determine whether the term was one the breach of which is capable of causing or contributing to loss. He concluded that "this might present serious difficulties, particularly in liability policies".

13.17 Secondly, he pointed out that the protectionist ethos behind the section could interfere with the parties' freedom to contract as they saw fit. He queried whether this restriction was desirable in a commercial context. He cautioned that the adoption of section 54 would be a sweeping reform which could unsettle the market for many years. The effect of its introduction was still being felt two decades after its introduction in Australia.

13.18 The Australian experience demonstrates how difficult it is to categorise terms in an insurance contract, or to specify the effect that each term should have. In Part 15 we propose a more cautious approach.

CANADA

13.19 In Canada, the Marine Insurance Act 1993 is based on the Marine Insurance Act 1906, although the two are not identical. In *The Bamcell II* the Supreme Court considered the consequences of a breach of warranty. The Court construed the warranty in a way which required the insurer to pay the claim where the breach had no bearing on the loss.[15]

13.20 *The Bamcell II* was a converted barge used for oceanographic experiments. In the policy, the insured "warranted that a watchman is stationed on board *The Bamcell II* each night from 2200 hours to 0600 hours with instructions for shutting down all equipment in an emergency".

13.21 The requirement was never complied with. The barge suffered fire damage during the mid afternoon; the insurer refused the insured's claim for breach of warranty. The court found that the breach had no bearing on the loss and that, despite the wording of the term it was not a true warranty but a suspensive condition which limited the risk insured.

13.22 The law has developed since this decision and it now appears that precise and unambiguous wording will establish a true warranty. A term in which the insured warranted that a barge would not be moved without the prior approval of underwriters, was held to be a true warranty in *Elkhorn Developments Ltd v Sovereign General Insurance Co.*[16] The Court of Appeal held that what was required was the intent that breach would automatically discharge the insurer's liability for loss. This had been demonstrated by the use of the word "warranty", the fact that both parties were sophisticated professionals and that cover notes repeated that the barge should not be moved without prior approval.

[14] Dr Baris Soyer, Reforming Insurance Warranties - are we finally moving forward? *Reforming Marine and Commercial Insurance Law* (2008).

[15] *Century Insurance Company of Canada v Case Existological Laboratories Ltd (The Bamcell II)* [1984] 1 Western Weekly Reports 97.

[16] 2001 BCCA 243.

13.23 In another case*, McIntosh v Royal & Sun Alliance,* the wording in a policy was pivotal to the finding that the term breached was a true warranty.[17] The claimant insured a high performance power boat for "pleasure use" but used it to carry paying customers. The boat was subsequently stolen. The Federal Court held that the clear language of the policy established the term was a true warranty. The policy drew a distinction between absolute and suspensive warranties and expressly stated that on breach of an absolute warranty, cover would terminate and would not be restored.

THE USA

13.24 Historically, US insurance law followed the British approach, but differences between the two have developed since the decision in 1955 of the Supreme Court in the *Wilburn Boat* case.[18] The court held that federal law should only apply to marine insurance where there was an entrenched rule; otherwise state law applied. This conclusion was based in part on the desire to avoid the severe consequence of breach of warranty in English insurance law. A small houseboat had been destroyed by fire at a time when the insured was in breach of a pleasure use only warranty. This should have resulted in the discharge of the insurer's liability, but the court held that the case was governed by a Texas statute for fire insurance which required that the breach should contribute to the loss.

13.25 The result of the decision in the *Wilburn Boat* case is that the way warranties are interpreted and applied is largely governed by state law. Some states, such as Texas, impose a causal connection test; others do not.

NEW YORK

13.26 New York state law does not require a causal connection between breach and loss. Instead, the test is whether the breach materially increases the risk of loss.

13.27 The New York Insurance Code, Article 31, section 3106(b) defines a "warranty" as follows:

> any provision of an insurance contract which has the effect of requiring, as a condition precedent of the taking effect of such a contract or as a condition precedent of the insurer's liability under it, the existence of a fact which tends to diminish, or the non-existence of a fact that tends to increase, the risk of the occurrence of any loss, damage or injury within the cover of the contract.

13.28 Under this definition, a warranty must go to the risk. Unlike the Australian reform it would not cover notification clauses or premium payment terms.

13.29 Under the Code, a breach of a warranty, as defined, does not avoid a contract or defeat a claim under it unless the breach materially increases the risk of loss, damage or injury within the cover of the contract. "Risk" in this context includes both physical and moral hazards.

13.30 Most express and implied warranties in marine insurance are excluded.

[17] 2007 FC 23.

[18] *Wilburn Boat Co v Fireman's Fund Ins* 348 US 310 (1955); [1955] AMC 467.

13.31 The effect of the Code is that "a policy will not be avoided by the proof of an immaterial breach".[19] The requirement of materiality was considered in *IRV-Bob Formal Wear v Public Service Mutual Insurance Co.*[20] The case concerned the theft of formal wear and the vehicle in which it was being transported. The policy contained an alarm protection warranty. This stated that it was a condition precedent to the insurer's liability and the effectiveness of the policy that the vehicle was equipped with a specified alarm, that it would be maintained in working order at all times, inspected at regular fixed intervals and that records of inspection and maintenance would be kept.

13.32 The insurer refused the claim for breach of the alarm protection warranty. The insurer could not prove to the court's satisfaction that the vehicle was equipped with the wrong alarm or that it had not been maintained as warranted. They were more successful with the allegation that records had not been kept but the court determined that, whether they succeeded on this point or not, it was "difficult to imagine how the presence or absence of such records could have materially increased the risk of loss". Conversely, inspecting and maintaining the alarm in working order "would be important with respect to the risk of loss".

GERMANY

13.33 German law adopts a fundamentally different approach to the management of risk to that under UK law; the concept of present fact and future warranties is unknown. Instead, the German Insurance Code, (the Versicherungsvertragsgesetz or VVG),[21] provides that an insurer may impose precautionary measures in the policy which must be complied with as a condition of the insurer's liability. In addition, during the currency of the policy the policyholder is under a duty not to aggravate the risk insured without the consent of the insurer. What an insurer may do in response to a breach of either a precautionary measure or the duty depends on the policyholder's degree of fault.

Precautionary measures

13.34 A term in an insurance contract can require that the policyholder observe an obligation as a condition that the insurer assumes liability for the insured risk, makes a payment on a claim or provide that on the non-observance of the term the insurer is entitled to terminate the contract.[22]

[19] *Glickman v New York Life Insurance Co* (291 NY 45, at 51).

[20] 81 Misc 2d 422, 366 NYS 2d 596, 86 Misc 2d 1006, 383 NYS 2d 832 (App Term 1976).

[21] See Part 3, para 3.17 and following which set out in greater detail the ambit of the VVG.

[22] See generally VVG s 28.

13.35 Where the policyholder has intentionally, or through gross negligence, breached a precautionary measure the insurer may terminate the contract without notice within one month of learning of the breach.[23] Where the breach is intentional, and where the contract makes express provision, the insurer may also refuse to pay a claim. Alternatively the insurer may reduce the amount payable commensurate with the degree of the policyholder's gross negligence.[24] In either case however, save where the policyholder has been fraudulent, there must be a causal link between the act complained of and the loss.[25]

Aggravation of the risk

13.36 Section 23 of the VVG provides that, on concluding the contract with the insurer, the policyholder may not aggravate the risk insured or permit its aggravation by a third party without the consent of the insurer. Where the policyholder realises that they have breached the duty that fact must be disclosed to the insurer without delay, as must any unintentional breach of which they become aware.[26]

13.37 Sections 24 to 26 of the VVG set out what the insurer may do in response to the policyholder's breach of the duty. The duty is not breached where the aggravation of the risk is immaterial or if it occurs in circumstances where the insurer is deemed to have consented to the breach.[27]

13.38 If the breach was intentional or the result of gross negligence the insurer may terminate the contract without notice.[28] Where the breach was negligent or unintentional the insurer has the right to terminate the contract on a month's notice; the right lapses after one month of the insurer learning of the breach or on the policyholder restoring the risk to that the insurer agreed to cover. [29]

13.39 Alternatively, the insurer may increase the premium payable from the date of breach commensurate with the increased risk or may exclude cover for that part of the risk. If, however, the premium is increased by more than 10%, or the proposed exclusion of the risk is not acceptable the policyholder may terminate the policy.[30]

13.40 The insurer is not liable for losses occurring after an intentional breach of the duty by the policyholder. Where the policyholder has been grossly negligent the insurer may reduce the amount to be paid on a claim commensurate to the policyholder's fault. In either case the aggravation must have caused or contributed to the loss claimed. [31]

[23] VVG s 28(1).

[24] VVG s 28(2).

[25] VVG s 28 (3).

[26] VVG ss 23(2) and 23(3).

[27] VVG s 27.

[28] VVG s 24(1).

[29] VVG, ss 23(1); 23(2) and 23(3).

[30] VVG s 25.

[31] The insurer is also prevented from taking either action where it knew about the breach but failed to terminate the contract within one month of acquiring the knowledge, see VVG s 26.

PRINCIPLES OF EUROPEAN INSURANCE CONTRACT LAW

13.41 At Part 3, we considered the Principles of European Insurance Contract Law (PEICL) in relation to the policyholder's duty of disclosure.[32] Here we consider how PEICL deals with the civil law equivalent to warranties, namely precautionary measures and the duty on the policyholder not to aggravate the risk.

13.42 PEICL draws on the civil law tradition and in particular Finnish Law.[33] It is more restrictive than UK law and takes a mandatory approach. A contract term which purports to exempt the insurer from liability is ineffective to the extent that it deviates from the PEICL regime.[34]

Precautionary measures

13.43 Article 4:101 defines a precautionary measure as:

> … a clause in the insurance contract, whether or not described as a condition precedent to the liability of the insurer, requiring the policyholder or the insured, before the insured event occurs, to perform or not to perform certain acts.

13.44 An insurer may include a contract term that non-compliance with a precautionary measure discharges its liability to pay a claim, but the effect of such a term is limited by Article 4.103 which provides:

> (1) A clause that non-compliance with a precautionary measure totally or partially exempts the insurer from liability, shall only have effect to the extent that the loss was caused by the non-compliance of the policyholder or insured with intent to cause the loss or recklessly and with knowledge that the loss would probably result.
>
> (2) Subject to a clear clause providing for the reduction of the insurance money according to the degree of fault, the policyholder or insured, as the case may be, shall be entitled to the insurance money in respect of any loss caused by negligent non-compliance with a precautionary measure.

13.45 Where the insured fails to comply with the precautionary measure, subject to limitations the insurer may terminate the contract. Article 4:102 provides:

> (1) A clause which provides that in the event of non-compliance with a precautionary measure the insurer shall be entitled to terminate the contract, shall be without effect unless the policyholder or the insured has breached its obligation with intent to cause the loss or recklessly and with knowledge that the loss would probably result.

[32] See para 3.27 and following.

[33] PEICL, p168 at para C.1

[34] Article 4:103(1)

> (2) The right to terminate shall be exercised by written notice to the policyholder within one month of the time when the non-compliance with a precautionary measure becomes known or apparent to the insurer. Cover shall come to an end at the time of termination.

Aggravation of the risk

13.46 Under PEICL, an insurer is permitted to include a term that the policyholder does not aggravate the risk. Article 4. 201, however, provides that such a term will be without effect unless two conditions are met. First, the aggravation must be material and second, it must be of a kind specified in the insurance contract.[35] Examples of aggravation of the risk that are not material are those caused by the natural wear and tear of property or the increasing age of a person covered by life or health insurance.[36] The requirement that the aggravation is of a specified kind is to bring to the attention of the policyholder the kind of aggravation the insurer considers material.[37]

13.47 The insurer is only entitled to refuse payment if the loss was caused by the specified aggravation of the risk.[38] Article 4.203(3) provides:

> If an insured risk is caused by an aggravated risk of which the policyholder is or ought to be aware, before cover has expired, no insurance money shall be payable if the insurer would not have insured the aggravated risk at all. If, however, the insurer would have insured the aggravated risk at a higher premium or on different terms, the insurance money shall be payable proportionately or in accordance with such terms.

13.48 All other losses falling outside of this scope remain due.

13.49 Insurers may include a term giving them the contractual right to terminate but this is regulated by Article 4.203, and must be exercised within a month of the insurer becoming aware (or when they ought to have been aware) of the insured's breach.[39] An insurer will remain liable for risks materialising within one month of the notice of termination being given (unless the policy holder has intentionally breached Article 4:202 where termination occurs when notice is given). [40]

[35] Where a contractual term imposes a duty not to aggravate the risk, Article 4. 202(1) imposes a duty on the policyholder to notify the insurer of the increased risk as soon as they become, or ought to have become, aware of the facts giving rise to the increased risk.

[36] PEICL, p 182, C4.

[37] Above.

[38] Above, Art 4:202(3).

[39] Above, Art 4:203(1).

[40] This is intended to allow insureds to find alternative cover.

CONCLUSION

13.50 Warranties are a common law concept, which do not have a direct equivalent in civil law jurisdictions. In Germany and under PEICL, for example, where an insured fails to comply with a precautionary measure, the insurer must still pay for losses which are not caused by the non-compliance. Even where losses are caused by the non-compliance, if the non-compliance is not intentional or reckless, the insurer is expected to pay for a proportion of the loss. The insurer's main remedy is to terminate the contract for the future.

13.51 By contrast, under the common law tradition, where a policyholder fails to comply with a warranty, the insurer is discharged from all liability under the policy. This can be a harsh outcome. Many common law jurisdictions have now reformed their law of warranties to prevent insurers from refusing claims where the breach of warranty is unconnected to the risk or loss. Having done so, no jurisdiction would return to the principles of the Marine Insurance Act 1906.

13.52 The experience in Australia and New Zealand, however, shows that it is difficult to define a warranty by its function. A causal connection test is suitable where the breach relates to a minor warranty, such as failure to install a lock or an alarm. It is more difficult to apply where the term defines the nature of the insurance – where for example the insurance only applies to the business of running a farm (and not to a tourist business), or specifies that a boat may only be used for pleasure use.

13.53 Under New York law, a breach must be material to the risk of loss. We have concluded that this appears to work more satisfactorily than a test based on causation. It moderates the consequence of breach of warranty to produce a fairer outcome for the parties involved, while preserving the important protective function of a warranty for insurers.

PART 14
WARRANTIES: THE CASE FOR REFORM AND CONSULTEES' VIEWS

PROBLEMS WITH THE CURRENT LAW

14.1 The current law of warranties set out in the Marine Insurance Act 1906 (the 1906 Act) appears unfair and unprincipled. There are four main problems:

(1) Under section 33(3) of the 1906 Act, a warranty "must be exactly complied with, whether it be material to the risk or not". This means that an insurer may refuse a claim for a trivial mistake which has no bearing on the risk.[1]

(2) Under section 34(2), once a warranty has been broken, the policyholder cannot use the defence that the breach has been remedied. Thus in strict law, if a policyholder is late in checking the alarm, it is irrelevant if the alarm is subsequently checked and found to be working before the loss arises.

(3) The breach of warranty discharges the insurer from all liability under the contract, not just for liability for the type of risk in question. Thus a failure to install the right sort of burglar alarm would discharge the insurer from paying a claim for fire damage.

(4) A statement may be converted into a warranty using obscure words that most policyholders do not understand. If, for example, a policyholder signs a statement on the proposal form that the answers given are "the basis of the contract", this can have draconian consequences.[2]

14.2 These provisions bring the law in the UK into disrepute in the international market place. The consequences lack "logical reason" and cannot be explained in terms of either legal fairness or economic efficiency.[3]

14.3 In practice, the courts have mitigated the harsh effect of the law by interpreting warranties strictly, or construing apparent warranties as other types of term. Although this does justice in individual cases, it introduces uncertainty and inconsistency into the law.

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

[2] See Part 12, para 12.17 and following.

[3] Professor Wilhelmsen "Duty of Disclosure, Duty of Good Faith, Alternation of Risk and Warranties: An Analysis of the Replies to the CMI Questionnaire", *CMI Yearbook 2000* pp 392 and 409.

SUPPORT FOR REFORM

14.4 Responses to our first Consultation Paper showed widespread support for reforming the law. This view was expressed with varying degrees of force. Professor Merkin urged "No warranties. Full stop!!!". Dewey & Le Boeuf said that warranties are a fundamental feature of re/insurance contracts, "for which there are perfectly legitimate reasons", but they agreed that:

> It is high time that the law of warranties is brought up to date. Courts have historically been reluctant to construe terms as warranties because of the draconian effects this may have. The current law whereby a breach of warranty unconnected with the loss results in discharge of the policy is a blunt and archaic instrument and needs to be reformed.

14.5 The Faculty of Advocates felt that reform was needed in "the interests of legal certainty and to enable the law to reflect current practice and a fair balance between the interested parties". The Bar Council confirmed that reform "would be in keeping with most people's sense of justice".

14.6 Many insurers and insurance organisations argued in favour of reform. The Chartered Insurance Institute supported reform which would bring about "a more consistent approach to the use of warranties". The Forum of Insurance Lawyers pointed out that although "the present regime developed for good reasons", "it is clear that the current legal position is confusing for insured businesses and individuals and appears to offer unfair results on occasions". They concluded that reform was "long overdue". RGA Reinsurance UK Ltd agreed, adding:

> Law reform has been recommended for many years and we are firmly of the view that now is the appropriate time to bring it up to date.

14.7 Endsleigh Insurance Services Ltd welcomed the proposed reform both as a means to update and clarify the "somewhat complex, confusing and sometimes inaccessible" current position.

14.8 There were dissenting responses but these were in the minority. The Association of British Insurers said that the current combination of law and regulation "works well for consumers and the industry", while for business customers "the guiding principle should be freedom to contract". A similar view was expressed by Fortis Insurance Ltd.

Reform for business insurance

14.9 Commercial buyers were strongly in favour of reform. Airmic believed that this was an essential change to insurance contract law. Martin Davidson, on behalf of the Network Rail Group Insurance Team, considered that industry self-regulation had been shown to be "largely ineffective, particularly for business buyers" and expressed concern that "too often a policyholder will be reliant on the insurer's goodwill in order that a claim is not rejected due to a technical breach of the law".

14.10 Barclays and HSBC argued that applying warranties in circumstances where the claim is unrelated to the breach is unjust. They said that they had the bargaining power, especially in a soft market, to negotiate warranties out of their contracts of insurance, but many smaller companies needed protection.

14.11 In 2011, the Mactavish Report[4] confirmed that it is mid-sized firms, turning over between £50 million and £5 billion, which are particularly vulnerable. In the study only two per cent of business customers had reviewed wording and held discussions with insurers about potential loss scenarios.[5] The authors comment that:

> Key legal terms such as warranties and their implications when it comes to policy coverage are not understood.[6]

14.12 The research found that insurers were already taking, and would continue to take a much tougher stance on claims. Firms could no longer rely on insurers' goodwill. Even if claims were not refused outright, insurers could use legal technicalities to cause difficulty and delay.

Reform for consumer insurance

14.13 For consumer insurance, there was support for bringing the law into line with current industry practice. As RBS Insurance said, "warranties are seldom used in personal lines and many of the Commission's proposals reflect established insurance practice that personal lines insurers have adopted over time".[7] This was confirmed by RGA Reinsurance UK Ltd:

> The current legal position is rarely applied to claims and it has to a large extent been supplemented by industry practice, industry codes and the Financial Ombudsman Scheme (FOS) guidelines. We do not regard the current situation as satisfactory for insurers or consumers as it is difficult for consumers and insurers to find out what their rights and responsibilities are.

14.14 By contrast, the ABI argued against change. They thought that the current mix of FSA rules and FOS discretion provided consumers with adequate protection and offered flexibility. Fortis Insurance Ltd expressed a similar view, namely that "market-based solutions" provide "a greater degree of flexibility than codified reform".

14.15 Other insurers argued against leaving the matter to FSA rules and FOS guidelines. As noted above, RGA Reinsurance UK Ltd thought that it was difficult for consumers and insurers to find out what their rights and responsibilities are. Furthermore, they commented that:

> The current situation allows the FOS, through its rulings, to act as a law maker, applying its decisions retrospectively and applying inconsistent standards. We would like to see the law rationalised so there is transparency in how the FOS applies the law.

[4] Corporate Risk & Insurance - The Case for Placement Reform. The Mactavish Protocols (2011).

[5] Above at p 6.

[6] Above, at p 12.

[7] Personal lines means insurance designed for personal use, that is, consumer insurance.

14.16 Aviva feared "regulation creep from, for example the FOS". They noted that "decisions from the FOS have been going above and beyond what is regarded as best practice".

Abolishing basis of the contract clauses

14.17 As we explained in Part 12, there was overwhelming support for abolishing basis of the contract clauses in consumer insurance and legislation has already been passed to this effect.[8]

14.18 There was also general support for abolishing basis of the contract clauses in business insurance. The Construction Industry Council commented that such clauses "are often seen by insureds as being pernicious"; they provide insurers with significant remedies of which the insured may be unaware "until the trap is sprung". Leeds Marine Insurance Association supported the proposal because basis of the contract clauses "have the effect of making all the clauses equally important".

14.19 Some consultees raised specific concerns. Brit Insurance Holdings Plc thought that an effect of the proposals would be to extend the lists of warranties in policies, which would make the documents more cumbersome. We disagree. Under the current law, policyholders need to check both the contract and the proposals form to find out about warranties. This is a clumsy arrangement: it would be better for the policyholder to have all the terms in one document.

THE 2007 PROPOSALS

14.20 Despite the widespread support for reform, respondents criticised some of the detailed proposals in the first Consultation Paper. In particular, it was thought overly complex to distinguish between warranties of specific fact and warranties involving future conduct. They also expressed concern about the proposed controls on standard term contracts which defeated the insured's reasonable expectations.

14.21 Below we provide a short summary of the warranty proposals in our 2007 Consultation Paper, before highlighting the concerns expressed.

Consumer insurance proposals

14.22 In 2007, we made the following proposals in respect of consumer insurance:

(1) Where a consumer makes a statement of *past or current fact* before entering an insurance contract, it should be treated as a representation rather than a warranty.

(2) Where a warranty concerned *future conduct*:

(a) It should be set out in *writing* and *brought to the consumer's attention*.[9]

[8] Consumer Insurance (Disclosure and Representations) Act 2012, s 6.

(b) The consumer should be entitled to be paid a claim if they could prove on the balance of probabilities that the event or circumstances constituting the breach *did not contribute to the loss*.[10]

(3) These rules would be *mandatory*, in the sense that the parties would not be free to change them by contract.[11]

Business insurance proposals

14.23 In 2007 we made the following proposals in respect of business insurance:

(1) In the absence of an agreement to the contrary, a *specific fact warranty* would entitle the insurer to refuse the claim, provided that:

(a) the warranty was *material*. For example, the insurer could not refuse a claim for a minor conviction (such as speeding) that would not have influenced its decision;

(b) it had some *connection to the loss*. For example, a manager's conviction for dangerous driving would be unconnected to a flood damage claim. [12]

(2) Where a warranty concerned *future conduct*:

(a) It should be set out in *writing*.[13]

(b) A business should be entitled to be paid a claim if it can prove on the balance of probabilities that the event or circumstances constituting *the breach did not contribute to the loss*. This would be a default rule. The parties could agree other consequences if they wished (subject to controls on standard term contracts).[14]

(c) A breach of warranty would not automatically discharge the insurer from liability, but would instead give the insurer *the right to terminate cover for the future*. We asked whether an insurer who terminates future cover should normally provide a pro-rata refund of outstanding premiums, less damages and reasonable administrative expenses.[15]

9 Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured; (2007) LCCP 182/ SLCDP 134, paras 8.8 to 8.19.

10 Above, paras 8.40 to 8.48.

11 Above, paras 8.49 to 8.50.

12 Above, para 5.132.

13 Above, paras 8.8 to 8.12.

14 Above, paras 8.51 to 8.53.

15 Above, paras 8.81 to 8.100.

(3) Where the parties contracted on the insurer's written standard terms of business, the insurer should not be permitted to rely on a warranty, exception or definition of the risk if this would render the cover substantially different from what the insured reasonably expected.[16]

CONCERNS ABOUT THE 2007 PROPOSALS

14.24 Concerns were expressed about three aspects of these proposals. First, consultees were worried about the complexity of the proposed scheme, which might introduce uncertainty into the law. Secondly, the controls on insurers' standard term contracts were felt to be unworkable. Finally, several consultees argued against the proposal that a policyholder should be entitled to be paid a claim where they could show that the breach did not contribute to the loss – the causal connection test.

14.25 We summarise these concerns below. We then look in more detail at whether the parties in business insurance should be entitled to contract out of the new rules.

Complexity

14.26 Several consultees thought that the proposals were unduly complex: especially the differences between present fact and future conduct warranties. Professors Merkin and Lowry described this complicated approach as "curious".[17] Addleshaw Goddard thought that the proposed reform might be unnecessarily complex and lead to more uncertainty and litigation.

14.27 Professor Baris Soyer cautioned that, "a sweeping reform which would change all parameters of underwriting practice is likely to unsettle the fine balance in the market". He felt that potential law reform should "aim to cure defects in the current warranty regime by avoiding, if possible, turbulence and uncertainty, which will naturally follow the introduction of novel legal concepts".[18]

Controls on standard terms

When do terms become standard?

14.28 The majority of consultees rejected the proposal to impose new controls on contracts written on insurers' written standard terms of business.

14.29 Consultees queried what was meant by "standard terms of business". It was pointed out that some terms were commonly used in insurance contracts while others were tailored for the individual policy. Many policies were a mix of the two.[19] A typical response was that of RSA who asked:

[16] Above paras 8.54 to 8.80.

[17] Merkin, Robert and Lowry, John, Reconstructing Insurance Law: The Law Commissions' Consultation Paper, (2009) *Modern Law Review*, 71, (1), 95-113.

[18] Baris Soyer, Reforming Insurance warranties – are we finally moving forward? *Reforming Marine and Commercial Insurance Law* [2008].

[19] We discussed the concept of written standard terms at paras 5.137 to 5.142 of the 2007 Consultation Paper.

> … If one or two terms are added to what is otherwise a standard wording does that make it non-standard?

14.30 Although the controls were not intended to apply to contracts drafted by brokers, there was thought to be potential for dispute over who had drafted which term. RSA added that there was also potential "for different views on the part of the insured, intermediary and insurer on whether a wording is 'standard' or not". AIRMIC agreed with the underlying principle of the proposal, but also queried when an insurer would be taken to have adopted brokers' standard wordings as their own.

The insured's reasonable expectations

14.31 We proposed that in standard term contracts, the insurer would not be permitted to rely on a warranty, exception or definition of the risk if it would render the cover substantially different from what the insured reasonably expected.

14.32 The reasonable expectation test also drew criticism. Brit Insurance, for example, considered it to be "far too ambiguous a test". Freshfields thought the test had "the potential to give rise to uncertainty and litigation". The test would entail "a consideration of the state of the market and of all the circumstances surrounding the negotiation of a policy, and not just the construction of the policy itself". Clyde & Co concluded that:

> The term "reasonable expectations" introduces a new and undesirable element of uncertainty, even if it is only a procedural safeguard. The matter can be adequately addressed by the English rules on incorporation of contract terms.

14.33 Professor Baris Soyer questioned the utility of the safeguard in that it did not go to "so-called substantive fairness (to control the fairness of the terms), but only so-called procedural fairness (the manner in which the terms were introduced into the contract)". The City of London Law Society made a similar point, noting that as the proposal only went to procedural unfairness it would "lack teeth".

Conclusion

14.34 We accept that our original proposals went too far. The proposals we are now making in Parts 15 and 16 are aimed only at specific problems with the law of warranties. We are no longer proposing controls on standard term contracts based on the insured's reasonable expectations.

The causal connection test

14.35 We proposed that for both consumer and business insurance the policyholder should be entitled to be paid a claim if it could prove on a balance of probability that the event or circumstances constituting the breach of warranty did not contribute to the loss.[20]

[20] LCCP 182/ SLCDP 134, para 12.55.

14.36 The proposal provoked a strong reaction. It enjoyed majority support, although this sometimes came with significant reservations. Some consultees were completely opposed. The main criticisms were that the test would be difficult to apply in practice; it was not appropriate for all warranties; and it might increase moral hazard.

Supporting comments

14.37 Several respondents supported the proposal strongly. AIRMIC believed that the introduction of a causal connection test was an "essential change to insurance contract law".[21] BILA thought it would "accord with most people's sense of justice". The Bar Council agreed, noting that most people would:

> … find it hard to comprehend why any breach of a warranty which did not contribute in any way to the loss, should result in their claim being denied.

14.38 Lord Justice Rix, Network Rail and Help the Aged also expressed support.

Causation is a difficult principle to apply

14.39 Professor Clarke warned that "the history of English law on questions of causation is not encouraging". That view was shared by other respondents who were concerned that introducing the test would necessitate a closer assessment of the exact chain of causation and the significance of potentially intervening events and that this could lead to increased litigation.

14.40 Swiss Re argued that a causal test would result in a clear increase in investigation costs which would be passed on to policyholders through the premium. The IUA also thought that "there will be a clear financial impact if the default causation regime is used".

The test is not appropriate for all terms

14.41 Some warranties may be relevant to the risk, but would not have a causal connection to the loss.

14.42 RBS Insurance agreed with the proposal when the "warranty is a specific risk requirement", but were concerned about warranties relating to moral hazard (such as those covering previous insurance history, convictions, bankruptcy or county court judgments). The British Maritime Law Association also saw difficulties in applying the test where the breach increases the risk, or the loss incurred, but could not be shown to have directly caused either. They used an example to illustrate the point:

[21] They did not explain however why they had reached this conclusion.

> An insurer covering an offshore construction project might wish as part of his risk management process to impose a warranty on the way the project is supervised and monitored. A loss might occur for a reason which has an independent cause but might well be indirectly related to slack quality control by the insured which is the real evil the insurer is seeking to control. It might be hard to prove any direct causal link but, if the insured had been compliant, the result might have been different or the extent of the loss smaller.

14.43 The Lloyd's Market Association and IUA also expressed concern about warranties which were safety critical or fundamental to the risk.

Undue formalism

14.44 In our 2007 Consultation Paper, we explained that if fundamental terms were written as suspensive conditions rather than as warranties, the causal connection test would not apply.

14.45 We illustrated this by looking at experience in New Zealand,[22] where a causal connection test was introduced by section 11 of the Insurance Law Reform Act 1977. As we discuss in Part 3, the section applies not just to warranties but to all terms which exclude or limit the insurer's liability on the happening of an event likely to increase the risk. The New Zealand Law Reform Commission recommended that the causation test should not apply to a list of terms, including terms which define the age, identity or experience of a driver or the geographical area in which a loss must be incurred.[23]

14.46 Our proposals were much more limited than the New Zealand provisions. We proposed that the causal connection test would apply only to warranties, strictly defined. It would not apply to definitions of the risk or exclusions, which would continue to operate as "suspensive conditions". Insurers could continue to write policies which defined the risk in such a way that the policy applied, for example, only to goods in the UK, or only if the forklift truck was operated by a trained driver over 21, or only if the car was used for domestic policies. Such suspensive conditions would not be subject to a causal connection test.

14.47 This introduced an element of formalism into the proposal which consultees found difficult to understand. Take an example where a ship owner warrants that a ship will not enter the Persian Gulf. At present, as soon as the ship enters the Gulf, the insurer is discharged from liability, even for a loss in the English Channel. Under our proposals, a loss in the English Channel would be covered. But what would be effect of our proposals if the ship was lost in the Gulf as a result of engine failure which could have happened anywhere?

[22] LCCP 182/ SLCDP 134, paras 8.13 to 8.45.

[23] See Part 8 at para 8.31 and following.

14.48 Under our 2007 proposals, the answer would depend on whether the term was written as a warranty or a "suspensive condition". If it were a suspensive condition, the claim would fail, because the loss fell outside the terms of the contract. If it were a warranty, however, then it would be open to the insured to argue that the ship's presence in the Gulf did not contribute to the loss, which would have happened in any event.

14.49 Consultees feared this would introduce unnecessary complexity and uncertainty. As we explained in Part 2, there is no clear definition of what constitutes a warranty. Insurers often argue that a term is a warranty, while policyholders argue that it is not. It was felt that our proposals would continue the same complexity but in a different way. Policyholders would argue that the term was a warranty (and should be subject to a causal connection test), while insurers would argue that it was a suspensive condition.

14.50 We accept that the causal connection test is unsuited to many terms, and that it would be unduly confusing to apply the test to warranties and not to suspensive conditions. As we explain in Part 5, under our new proposals, warranties would be treated in a similar way to suspensive conditions, removing unnecessary distinctions between the two.

FREEDOM OF CONTRACT

14.51 In the Consultation Paper we explained that for business contracts, freedom of contract would be preserved. The causal connection test was only a default rule. The parties could agree to contract terms which specified other consequences if they wished.

14.52 Most insurers and insurance organisations supported this emphasis on freedom of contract. The ABI felt that for business customers "the guiding principle should be freedom to contract".

14.53 Other consultees were concerned that it would weaken the reforms overall. They thought that it was wrong to assume that even relatively sophisticated businesses would have the clout to negotiate a contract so that the default position applied. Peter Franklin thought that it should not be the default for business insurance as "insurers are in too powerful [a] position to dictate terms". Aon were concerned that opting out would quickly become standard practice "driven by the market's wish to retain its historically powerful position".

14.54 The ABI and Fortis Insurance Ltd questioned whether, given that the parties could opt out, there was any need for the proposed reform. We think that there is. The need for an express opt out provision to be brought to the policyholder's attention will discourage insurers from using warranties unreasonably. AIRMIC supported the proposals so long as safeguards were "in place to ensure that the insured is made explicitly aware that the contract is not subject to the default regimes".[24]

[24] This approach has been adopted in other statutory schemes for similar reasons. For example, in England and Wales under the Landlord and Tenant Act 1954, Part II, a business tenant can opt out of the protection of the Act but must do so expressly and in writing.

14.55 A guiding principle for our reform is that business parties should be free to contract, provided that both sides understand and agree to a term. In Part 5 we explain that our main proposals would operate as default provisions, which could be overturned by contractual terms, provided that those terms were clear and unambiguous, and sufficiently brought to the attention of the other party.

CONCLUSION

14.56 The arguments raised have highlighted significant drawbacks with the proposal, not least that it would introduce unpredictability into the law. In relation to our proposed reforms Professor Baris Soyer made the acute observation that, "the desire to create a fairer regime can carry with it a real price in the shape of uncertainty".[25]

14.57 We remain of the view that the effect of breach under the current law is draconian and should be reformed. We have, however, revised our thinking on what shape that reform should take.[26] Our new proposals, set out in Part 15, are targeted at the specific problems in the law of warranties. We have not attempted to control all contract terms in standard contracts; nor have we reclassified the various terms which might exist in an insurance contract. It is clear that a causal connection test is not appropriate for all contract terms, and we think it would generate too much uncertainty to attempt to apply such a test to some terms and not others.

14.58 Our main proposal is to apply the same consequences to a breach of warranty as would apply to a breach of a suspensive condition. If this is not suited to a particular case, the parties should spell out other consequences clearly in their contracts. This would cure the specific mischiefs in the Marine Insurance Act 1906, and remove uncertainty over the distinction between warranties and other term.

[25] Baris Soyer, "Reforming Insurance Warranties – Are we finally moving forward?" *Reforming Marine and Commercial Insurance Law*, (2008) at p 144.

[26] See Part 15 at para 15.21 and following.

PART 15
WARRANTIES: PROPOSALS FOR REFORM (1)

OUTLINE

15.1 In this Part, we set out three proposals to address the defects in the law of warranties:

(1) First, we propose to abolish basis of the contract clauses. Any clause which purports to give warranty status to answers on a proposal form should be of no effect. If an insurer wishes to use warranties of past or present fact, these should be included expressly in the contract.

(2) Our second proposal is aimed specifically at warranties, as traditionally defined. At present, if a warranty is not complied with, the insurer is automatically discharged from liability. We propose instead that the insurer's liability should be suspended for the duration of the breach. This means that if the breach has been remedied by the time of the loss, the insurer must pay the claim (subject to any other available defence).

(3) The third proposal would not be confined to traditional warranties. It would apply to any contract term designed to reduce the risk of a particular type of loss. Obvious examples are terms to install burglar alarms or sprinkler systems. Many such terms are described as "warranties", but they are not necessarily warranties in the strict sense of the word. Nor are all warranties about particular risks.

Therefore, we propose that where a term is designed to reduce the risk of a particular loss, then a breach of that term should only suspend liability in respect of that type of loss. Thus a requirement to install a mortice lock would suspend liability for theft loss but not for fire loss. The same would apply where the term was designed to reduce the risk of loss at a particular time or in a particular location. A failure to employ a night watchman would suspend the insurer's liability for losses at night, but not for losses during the day.

15.2 In consumer insurance, the reform would be mandatory and could not be excluded by a contract term.

15.3 In business insurance, the parties would be able to contract out of these provisions. The contract may, for example, specify that breach of a particular term will absolve the insurer of all liability under the contract – not just for the risk in question. This, however, would need to be spelled out in clear, unambiguous terms and specifically brought to the attention of the other party.

15.4 Finally, we consider whether a warranty should be in writing to take effect, as was initially proposed in the 2007 Consultation Paper.[1]

[1] Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured, (2007) LCCP 182/SLCDP 134, para 8.12.

AN ILLUSTRATION

15.5 It may be helpful to illustrate the effect of these proposals with a short example. A couple insure a small yacht. The policy includes three warranties:

(1) A "premium payment" warranty, requiring payment by 1 June;

(2) A "lock warranty" requiring the hatch to be secured by a special type of padlock; and

(3) A "pleasure use only" warranty, forbidding the yacht to be used for commercial gain.

15.6 The policyholders breach all three warranties. They fail to pay until 15 June; they install the wrong type of padlock; and they use the yacht for paid fishing trips. On 1 July the policyholders are using the yacht to transport paying customers when it is hit by a sudden hurricane and sinks.

15.7 The effect of each breach would be as follows:

(1) Under the current law, breach of a premium payment warranty discharges the insurer from liability, which is not restored if the insurer later accepts payment.[2] Under our proposals, however, the payment on 15 June would remedy the breach and the insurer's liability would be restored. The insurer would not be permitted to reject the claim solely on this basis.

(2) The lock warranty is aimed at a specific type of loss: loss by theft. Under our proposals, it would not suspend the insurer's liability for other types of loss, such as loss in a storm.

(3) The pleasure use only warranty relates to the contract generally, and suspends the insurer's liability for all losses until such time as it is remedied. Clearly in this case it has not been remedied, and the insurer may reject the claim on this basis. It does not matter whether the breach caused the loss. As we discuss below, if the yacht has been used commercially, the insurer may also refuse claims for losses which occur overnight, when no paying passengers are on-board.[3]

15.8 Below we consider each proposal in more detail. In Part 16, we then describe how our proposals would apply to marine insurance and reinsurance.

PROPOSAL 1: ABOLISHING BASIS OF THE CONTRACT CLAUSES

15.9 As we saw in Part 12, a "basis of the contract" clause converts the policyholder's answers and declarations into contractual warranties. Typically, the policyholder signs a statement on the proposal form stating that the answers form the basis of the contract. This adds to the insurer's normal remedies for misrepresentation. It gives the insurer the right to refuse claims when the policyholder makes any mistake, even a minor or immaterial one.

[2] See Part 12, at para 12.33.

[3] Paras 15.18 to 15.19.

15.10 Basis of the contract clauses operate as traps. As discussed in Part 4, there was general support for their abolition.

15.11 The Consumer Insurance (Disclosure and Representations) Act 2012 abolished basis of the contract clauses in consumer insurance.[4] Section 6 deals with representations made by consumers in connection with a proposed consumer insurance contact or variation. It provides that such representations cannot be converted into warranties by means of a declaration on a proposal form or in any other document or contract. It remains possible, however, for the insurer to include specific warranties of fact in a policy, dealing with similar issues to matters dealt with in the application form.

15.12 We propose the same approach for business insurance. It would not be possible for an insurer to convert the answers on a proposal form into warranties by means of contract term or some other statement. Any such term would be of no effect. If the insurer wishes to include specific warranties, these would need to be spelled out in the policy.

15.13 **Do consultees agree that, in business insurance, a term in a proposal form, contract or accompanying document which states that the policyholder warrants the accuracy of the answers given or that the answers form the basis of the contract should be of no effect?**

PROPOSAL 2: WARRANTIES AND THE SUSPENSION OF LIABILITY

15.14 Section 33(3) of the Marine Insurance Act 1906 (the 1906 Act) states that a warranty must be exactly complied with. If not, "the insurer is discharged from liability as from the date of the breach of warranty". The main effect is then spelled out in section 34(2): "the assured cannot avail himself of any defence that the warranty has been remedied, and the warranty complied with, before loss".

15.15 This is clearly unjust. It is wrong to refuse a claim for delay in inspecting a sprinkler system when, at the time of loss, the sprinkler has been inspected and is working perfectly. In attempting to escape the harshness of the 1906 Act provisions, the courts have been forced to reinterpret clauses designed as warranties as terms which are not warranties, introducing considerable confusion into the law. The concept of automatic discharge also introduces complexities into the law of waiver.[5]

15.16 We propose to change the law to the effect that if a warranty is not complied with, the insurer's liability is suspended for the duration of the breach. If the breach is remedied, liability would be restored.

[4] 2012 c 6.

[5] See Part 12, at para 12.36 and following.

15.17 We do not think that this is a controversial proposal. Insurers value warranties as an effective means to manage risk, but it is clear from their responses that most do not wish to use warranties oppressively where faults have already been remedied. It is also in line with the approach already taken by the courts in cases such as *Kler Knitwear*.[6] Furthermore, the proposal does not introduce untoward distinctions between types of term. As Professor Baris Soyer commented, reform of this type, where breach merely suspends cover, "is not likely to create any serious difficulty".[7] Finally, we think that the reform would encourage compliance. Policyholders will be more inclined to remedy problems if they know that the effect will be to restore cover.

What amounts to a remedy of the breach?

15.18 Liability would only be restored if the breach was remedied. In the yacht example given above, the policyholders breached a "pleasure use only" warranty. What would be the effect if the policyholders routinely used the yacht for commercial purposes, but the yacht was damaged overnight, while berthed?

15.19 These circumstances are similar to the case of *Murray v Scottish Automobile*, where a car insured for private use was used as a taxi.[8] It was damaged by fire while parked overnight in a garage. The Court of Session held that the "private use" term was descriptive of the risk. Nevertheless, the insurer was not liable to pay the claim. Lord Sands stated that the time the car was parked in the garage "must be attributed to one use or the other". It was best seen as ancillary to the use to which the car has been put during the day. On this logic, the car was still being used as a taxi when parked overnight, and the insurer was not liable to pay the claim. We think the same rule would apply to the yacht.

15.20 In some cases remedy of the breach may not be feasible on a practical level. If a policyholder warrants that a house is brick when in fact it is timber-framed, it may be difficult to remedy the breach without tearing the house down and rebuilding it. In other cases, remedy may be impossible. If a policyholder warrants that a house has not flooded in the last 50 years, it is impossible to undo the fact that a flood occurred in 2003. We still think, however, that it is helpful to think of liability being suspended rather than automatically discharged. Cover may be restored if the policyholder tells the insurer about the flood and the insurer waives the breach. We discuss waiver in more detail below.[9]

The format of the reform

15.21 Reforming the Marine Insurance Act 1906 is a complex operation, as it operates in two ways. It has statutory authority for marine insurance; and has also been recognised as embodying common law principles for all forms of insurance. Thus it is not enough to repeal or amend the Act itself. One also needs to amend the common law principles lying behind the Act.

6 See Part 12 at para 12.47 and following and see *Kler Knitwear Ltd v Lombard General Insurance Ltd* [2000] Lloyd's Rep IR 47QBD.

7 Baris Soyer, "Reforming Insurance Warranties – are we finally moving forward?" *Reforming Marine and Commercial Insurance Law* (2008).

8 1929 SLT 114.

9 See para 15.27 and following.

15.22 We have considered how to define a warranty for the purposes of this proposal. Our current view is that we should leave the existing definition under section 33(1) of the 1906 Act intact. It is true that there is considerable uncertainty as to how this definition operates. In many cases it has been argued that a term which appears to be a warranty under section 33(1) is merely a suspensive condition. Under our proposal, however, this problem disappears. Definition of the risk, exclusions and warranties would all be treated in the same way: liability would be suspended.

15.23 If we change the definition, there is a danger that the common law position will re-emerge: someone may argue that the common law applies to terms which would be warranties under the old definition, but which are not warranties under the new definition.

15.24 The most straightforward way to achieve the policy behind this proposal may be to re-enact sections 33 to 35 of the 1906 Act for all insurance contracts, with whatever consequential amendment was necessary to accommodate the reforms. We would retain section 33(1) which defines a warranty; and section 33(2) which states that it may be express or implied. Section 33(3) would be changed. We do not see any reason to retain the current provision that a warranty "must be exactly complied with, whether it be material to the risk or not". The statement that the insurer is discharged from liability would be replaced by a statement that liability is suspended. Section 34(2) would also be amended to state that a breach may be remedied and liability restored.

15.25 **Do consultees agree that where a warranty is not complied with:**

(1) the insurer's liability should be suspended; and

(2) liability should be restored where the policyholder remedies the breach?

Excused non-compliance and waiver

15.26 Section 34(1) of the 1906 Act provides that non-compliance with a warranty is excused when, by reason of change of circumstances, the warranty ceases to be applicable to the circumstances of the contract or when compliance is rendered unlawful by subsequent law. We think this is an important protection for the policyholder and that it should be retained.

15.27 Section 34(3) states that "a breach of warranty may be waived by the insurer". As we discussed in Part 12, there is considerable academic debate about how waiver is compatible with automatic discharge of liability. It appears that any waiver must be "by estoppel", rather than "by election". Waiver by estoppel is a discretionary remedy. The policyholder must show that they relied on the insurer's unequivocal representation in circumstances where it would be inequitable for the promise to be withdrawn.[10]

[10] See Legh-Jones, Birds and Owen, *MacGillivray on Insurance Law* (2008 11th ed) paras 10-106 and 10-107.

15.28 The conceptual difficulties over waiver are removed if a breach of warranty merely suspends the insurer's liability rather than discharging it. It means that in most circumstances waiver will be by election, though waiver by estoppel will still be available in appropriate cases. These conceptual difficulties should not impact on Scots law where waiver is a flexible concept.[11]

15.29 We propose to retain section 34(3) of the 1906 Act so that a breach of warranty may be waived. We do not think we need to specify how an insurer may waive a breach of warranty. The matter can be left to the general law. This view was shared by consultees. RBS Insurance thought that, "if waiver and affirmation is to be governed by the general rules of contract we see no need to enshrine the rules in any new legislation"; while Herbert Smith also expressed doubt that "any specific provision is required".

15.30 **Do consultees agree that sections 34(1) and 34(3) of the Marine Insurance Act 1906 should be retained?**

Should insurers be given a statutory right to cancel?

15.31 In 2007 we proposed that where the policyholder has breached a warranty, the insurer should have a right to cancel the contract by giving reasonable notice, and returning premiums on a pro-rata basis.

15.32 Consultees generally supported this proposal but felt that it was of limited use. It was pointed out that policies often include a contractual right to cancel. In most cases, the insurer will not learn of the breach until a loss has arisen. In some cases the policy may have expired. We agree that the right to cancel is of only secondary importance. Under our current proposals, the insurer's primary remedy is that the insurer is not liable to pay a claim while the policyholder is in breach. Nevertheless, we think that the right to cancel may be a useful additional right in some circumstances. As the International Group of P&I Clubs told us, a failure to comply with Club Rules "is likely to be revealing of that member's general attitude and behaviour". Once an insurer has discovered a breach of warranty, it may lose faith in the policyholder's ability to manage risk. It may therefore wish to terminate the relationship.

15.33 The question is whether a right to cancel should be introduced by statute, or whether it is best left to contractual terms. On balance, we think that the matter is best left to the terms of the contract. A statutory right to cancel may be overly complex, especially if it included provision for reasonable notice and pro-rata repayment, as we provisionally concluded that it should. It would be in addition to any contractual right and as such would be unlikely to serve any useful purpose.

15.34 **Do consultees agree that where the policyholder breaches a warranty, the insurer's right to cancel the contract should be contractual rather than statutory, and therefore governed by the terms of the contract?**

[11] See Part 12 at para 12.37 and following.

PROPOSAL 3: TERMS TO REDUCE PARTICULAR RISKS

15.35 The third proposal would apply to any term which has the purpose of reducing the particular risks. Where a term is designed to reduce the risk of a particular type of loss, we think that a breach of that term should only suspend liability in respect of that type of loss. Thus failure to comply with a requirement to regularly inspect and maintain fire retardant lagging in kitchen ducting should suspend liability for fire loss but not theft loss. The same should apply where the term is designed to reduce the risk of loss at a particular time or in a particular location. A failure to employ a night watchman should suspend the insurer's liability for losses at night, but not for losses during the day.

What terms would be covered by this proposal?

15.36 Proposal 3 would operate in a different way from Proposal 2. It would not apply solely to warranties as traditionally defined. Instead it would apply to any term which had the purpose of reducing the risk of a particular type of loss, or of loss at a particular time or in a particular place.

15.37 Clearly, many warranties fall into this category. For example, warranties to install locks are designed to reduce the risk of theft. Hot works warranties are designed to reduce the risk of fire. That said, as we explain below, the category of term covered by Proposal 3 is both narrower and wider than the definition of a warranty.

15.38 First, not all warranties are aimed at reducing particular risks. Some address moral hazard, for example those relating to a policyholder's criminal record. Some define the whole contract, such as a term restricting cover to a farming business (and not tourism).[12] These terms would not be affected by this proposal. Nor would the proposal affect terms which have no bearing on the risk of a loss, such as premium payment warranties.

15.39 Secondly, not all terms designed to reduce risk are "true warranties" within the section 33 definition. In Part 2, for example, we discussed the case of *Sugar Hut Ltd v Great Lakes Reinsurance (UK) Plc,* where the judge suggested that the burglar alarm warranty may not be a true warranty, but only a suspensive condition.[13] The proposal would apply to such a term irrespective of whether it was a warranty under the current law. We would not wish litigants to continue these disputes about what is or is not a warranty, or to argue that our proposal did not apply because the term was not really a warranty.

Illustrations

15.40 It may be helpful to illustrate the effect of this proposal by looking at court decisions in the UK and overseas.

[12] See, for example, Part 13 at para 13.7.

[13] [2010] EWHC 2636.

Vesta v Butcher

15.41 In *Forsikringsaktieselskapet Vesta v Butcher,* a Norwegian insurance company provided cover for a fish farm which contained a warranty that the insured should keep a 24 hour watch at the farm.[14] It was not complied with. After a severe storm, many fish were lost. Under Norwegian law, the insurer was liable to pay the claim. The reinsurance, however, was written under English law, and the reinsurer argued that it was not liable to indemnify the direct insurer as the warranty had been breached. The court accepted that this was the position in English law, but found against the reinsurer on the basis that this particular reinsurance contract was subject to Norwegian law on this issue.[15]

15.42 The warranty for the provision of a 24 hour watch was material to the security of the farm and the risk of loss through theft or vandalism. Under our proposal, the insurer's liability would only be suspended in respect of that risk. Both the insurer and the reinsurer would have been liable to pay a claim for storm damage.

The Bamcell II

15.43 In *The Bamcell II,* the owners of a converted barge warranted that a watchman would be employed at night, and the barge suffered fire damage during the mid afternoon.[16] When faced with the unfairness of denying the claim, the Supreme Court of Canada decided that the term was not a warranty, an uncomfortable finding given the clear wording used. Under our proposal the insurer's liability would be suspended only in relation to losses at night. Other losses would be paid.

Printpak v AGF

15.44 In *Printpak v AGF Insurance Ltd*, the insurer refused a claim for fire loss because the policyholder was in breach of a warranty to install and maintain a burglar alarm.[17] English courts reached the outcome we are proposing by construing the policy, which was set out in different sections covering different risks. The court found that even though the policy was a single contract it was not "a seamless contractual instrument".[18] The warranty did not cover every section of the policy but only the theft section into which it was incorporated.

[14] [1989] AC 852.

[15] In this case, the reinsurance was considered to be "back to back" with the direct insurance, but see *WASA v Lexington* [2009] UKHL 40, [2010] 1 AC 180 and see Part 9, para 9.43 and following. See also O'Neil and Woloniecki, *The Law of Reinsurance*, (3rd ed 2010), at paras 4-22 to 4-24 and at paras 4-070 to 4-074, where it is argued that there is no presumption in non-proportional reinsurance that it is written on a "back to back" basis and that for proportional reinsurance there is only a "cautious" presumption that it is.

[16] *Century Insurance Company of Canada v Case Existological Laboratories Ltd ("The Bamcell II)* [1984] 1 Western Weekly Reports 97.

[17] *Printpak v AGF Insurance Ltd* [1999] 1 All ER (Comm) 466, CA; [1999] Lloyd's Rep IR 542.

[18] Above by Hirst LJ at 549.

Sugar Hut

15.45 In *Sugar Hut Ltd v Great Lakes Reinsurance (UK) Plc,* the claimants insured four night clubs, and claimed for a fire in the Brentwood club. The court rejected the policyholder's claim on several grounds, including non-disclosure and breach of warranty.[19] Two warranties are worth noting.

15.46 The first was described as the "kitchen warranty". It specified that:

> … all frying and other cooking ranges, equipment, flues and exhaust ducting will be kept securely fixed and free from contact with combustible materials …

15.47 The court found that the kitchen flues contacted combustible material in four places, though this was not how the fire started. Mr Justice Burton held that this was "a true warranty", rather than merely a suspensive condition. Counsel for the policyholders pointed out that this finding could have potentially drastic consequences. The policy covered four separate night clubs. If the law was applied strictly, then the faulty flue in the Brentwood club would discharge the insurer from liability for all claims in any of the four locations. The judge agreed, where four premises are the subject matter of one insurance then the breach of a true warranty does indeed impact on all of them:

> That is however the consequence of having cover for four premises included in one policy, and it could presumably have been an option for there to be four separate policies.

He noted that in this case, however, the fire occurred in the same premises as the faulty flues.

15.48 We think the kitchen warranty was designed to reduce the risk of a fire in the kitchen at the Brentwood club. Thus, under our proposal, the insurer's liability would be suspended for any fire losses connected with the Brentwood kitchen. We do not propose to introduce a causal connection test, so it is irrelevant that the fire was not started by the faulty flue.

15.49 On the other hand, we think it is wrong that the insurer should be absolved from liability for all claims, including claims which arose in other locations. We do not think it is helpful simply to warn businesses to take out separate policies on each of their buildings. Combined policies are administratively simpler for both parties. The Mactavish Report shows that very few businesses understand the legal consequences of warranties, or would have borne this scenario in mind when deciding whether to take out separate or combined policies.[20]

15.50 We recognise that there may be borderline cases that turn on their particular facts, such as whether a term was directed only at fire in the kitchen or at fire within any part of the building. The proposals, however, focus on the real issue - which is what the term was designed to do in relation to the risk.

[19] [2010] EWHC 2636, [2011] Lloyd's Rep IR 198.

[20] Corporate Risk & Insurance -The Case for Placement Reform. The Mactavish Protocols (2011) and see Part 14 which considers at the case for reform.

15.51 The second warranty was to install a particular type of burglar alarm, which the policyholder had breached. As we discussed in Part 2, the court found that this was in itself sufficient grounds to refuse the fire claim. Our proposal would reverse this outcome. The purpose of the burglar alarm warranty is to reduce the risk of intruders, and should not affect a fire claim.

15.52 In the *Sugar Hut* case, the burglar alarm issue was a subsidiary issue, and the case was mainly decided on other grounds. We do not think it helpful, however, that insurers are encouraged to prolong litigation by raising unconnected issues of this type.

15.53 **Do consultees agree that:**

(1) Where a term is included to reduce the risk of a particular type of loss, then in the event of a breach of the term, the insurer's liability should be suspended only in respect of that type of loss?

(2) Where a term is included to reduce the risk of a loss at a particular time or in a particular location, then in the event of breach of the term, liability would be suspended only in relation to losses at that time or at that location?

CONTRACTING OUT

15.54 These rules would be mandatory for consumer insurance. Our intention would be to follow the definition of consumer insurance contained in the Consumer Insurance (Disclosures and Representations) Act and include a clause similar to the prohibition on contracting out in section 10 of that Act.[21]

15.55 In business insurance, the parties would be entitled to specify that a breach of warranty has different consequences. Where, however, the insurer wished to retain the right to reject claims for breaches which had already been remedied, this would need to be spelled out in clear and unambiguous terms, and specifically brought to the attention of the other party before the contract was formed. A similar rule would apply if an insurer wished to be able to reject a claim for breach of a term related to a different type of loss (or loss at a different time or in a different place).

15.56 This means that in business contracts, insurers will still be able to state, for example, that a breach of a term about a burglar alarm will lead to fire claims being rejected. This consequence, however, would need to be spelled out in clear, unambiguous terms and specifically brought to the policyholder's attention. By this, we mean more than the fact that the policyholder must be told that they need to install a new burglar alarm. The policyholder must be told, specifically, before entering the contract, that if they do not install a burglar alarm the insurer will refuse a fire claim. We think that insurers may be reluctant to do this unless such a term is highly significant for them.

[21] 2012 c 6.

15.57 This is similar to the approach we have taken in relation to other default rules. For example, in our joint Consultation Paper on *Insurance Contract Law: Post Contract Duties and other Issues*,[22] we proposed statutory remedies where a policyholder commits fraud in relation to a claim. We also proposed that these would be subject to an express term of the contract which could extend the insurer's remedies, but the term should be written in clear unambiguous terms and be specifically brought to the attention of the other party.

15.58 We think that this reflects current best practice. It also provides an appropriate level of safeguard for business policyholders.

15.59 **Do consultees agree that:**

(1) In consumer insurance, a term which purports to put the consumer into a worse position as regards breach of warranty than that set out in the proposed reform should be of no effect?

(2) In business insurance, a term which permits an insurer to refuse a claim

(a) for a breach of warranty which was remedied before the loss; or

(b) for breach of a term designed to reduce the risk of another type of loss (or loss at a different time or place)

is only effective if it is written in clear, unambiguous language and specifically brought to the attention of the other party before the contract is formed?

THE REQUIREMENT FOR WRITING

15.60 In 2007 we proposed that a warranty should be set out in writing. We thought that in consumer insurance, it should be brought to the consumer's attention. Most consultees agreed. In fact, many respondents could not envisage a case involving an allegation of breach of warranty where the warranty was not in writing.

15.61 In marine insurance, there must be a written policy. Section 22 of the Marine Insurance Act 1906 states that "a contract of marine insurance is embodied in a marine policy". Section 35(2) then requires that :

> An express warranty must be included in, or written upon, the policy, or must be contained in some document by reference into the policy.

15.62 These provisions are confined to marine insurance and do not apply to other forms of insurance.

[22] (2011) LCCP 201/ SLCDP 152.

15.63 In our 2011 Consultation Paper we criticised the requirement for a formal written marine policy.[23] The requirement originated in 1795 as a way of preventing the evasion of stamp duty. As stamp duty on marine policies was abolished in 1970, its rationale has disappeared. The requirement no longer accords with market practice, and we proposed that it should be repealed. Although it is clearly desirable to put contract terms in writing, we thought that it should be a matter for the industry (backed if necessary by regulation). Most consultees agreed that statutory requirements for formality have the potential to cause problems.

15.64 Even if there is no general requirement for an insurance contract to be writing, there is a case that particularly important or draconian terms should be in writing. In 2007 we argued that warranties were so important that they should be treated differently from other terms although we noted that imposing such a requirement would not involve any significant change in practice: insurers will almost always put significant terms in writing.

15.65 Under our current proposals, however, warranties will be treated much like definitions of the risk and exclusions for which there is no requirement for writing, and all of which result in the suspension of liability if breached. We no longer see that there is any particular need to single warranties out as requiring writing if this is not the case for other terms. To do so may lead to technical arguments about the classification of terms, something we do not want to encourage.

15.66 We have concluded that this proposal is unnecessary. In business insurance, insurers already put warranties in writing, and this will continue. In consumer insurance, insurers already need to comply with Financial Services Authority rules on key facts documents. We do not see the need to distinguish between warranties and other terms, by requiring warranties to be in writing.

15.67 **Do consultees agree that an express requirement that, in order to take effect, a warranty must be in writing is not necessary?**

[23] Insurance Contract Law: Post Contract Duties and other Issues (2011), LCCP 201/SLCDP 152, Part 15.

PART 16
WARRANTIES: PROPOSALS FOR REFORM (2)

MARINE INSURANCE

Express warranties

16.1 In 2007, we argued that the same rules should apply to both marine and non-marine insurance. We thought it would be overly complex to apply one law to (for example) major construction projects, and quite a different law to ships. Over two-thirds of those who responded agreed, especially as parties would be entitled to contract out of the default position if they wished.

16.2 We think that the rules which we have outlined above should apply equally to express warranties in marine insurance. This would reverse the outcome in *De Hahn v Hartley* that a breach of warranty cannot be remedied.[1] If, for example, a ship warrants a crew of 50 or more, but leaves port with a crew of 46, we think this should suspend the insurer's liability rather than discharge it. Once the breach is remedied, and additional crew members are aboard, liability should resume.

16.3 We think that this would be a fairer result, and bring UK law closer in line with international standards. In Part 13, we noted that most common law jurisdictions have now rejected the UK approach, which has often been criticised in scathing terms.[2] It was, for example, rejected by the US Supreme Court in *Wilburn Boat*,[3] and by the Supreme Court of Canada in *Bamcell II*.[4] The Australian Law Reform Commission (ALRC) reviewed marine insurance law in 2001, following complaints from the fishing industry, and recommended that a breach of warranty should only justify avoiding a claim if it proximately caused the loss.[5]

1 (1786) 1 TR 343.

2 See, for example, Professor Trine-Lise Wilhelmsen, *Duty of Disclosure, Duty of Good Faith, Alternation of Risk and Warranties: An Analysis of the Replies to the CMI Questionnaire*, CMI Yearbook 2000 p 392, and Professor Hare, *The Omnipotent Warranty: England v The World*, paper to the International Marine Insurance Conference, November 1999.

3 *Wilburn Boat Co v Fireman's Fund Ins* 348 US (1955); (1955) AMC 467.

4 *Century Insurance Company of Canada v Case Existological Laboratories Ltd (The Bamcell II)* [1984] 1 WWR 97. See also Part 13, at paras 13.19 to 13.23 and para 13.24 and following.

5 ALRC No 91.

16.4 It would also remove the problem of defining marine insurance. As we discussed in our earlier joint Consultation Paper *Insurance Contract Law: Post Contract Duties and other Issues*,[6] the dividing line between marine and non-marine insurance is far from clear, with considerable uncertainty over whether insurance on fixed platforms, shipbuilding or air cargo can be classified as marine insurance.[7] The distinction between marine and non-marine insurance has caused particular difficulties in Australia.[8]

16.5 **Do consultees agree that the rules outlined above should apply to express warranties in marine insurance?**

The implied marine warranties

Should the implied warranties be retained?

16.6 The 1906 Act implies four warranties into marine insurance contracts: seaworthiness, portworthiness, cargoworthiness and legality.[9] We examined these at length in the 2007 Consultation Paper and asked whether they should be retained.[10]

16.7 Most marine insurers argued that the implied warranties should be retained. The International Group of P&I Clubs said that they were very important:

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

16.8 The LMA commented that it was "not aware of any significant discontent on the part of the insurance buying community or their representatives"; they noted that "not everything can be written into the contract" and that the implied warranties dealt with "very basic factors on which risk is rated". Dewey & Le Boeuf thought that the implied warranties provided "significant, reasonable and recognised protection for an insurer".

16.9 This view was not universal. Several brokers and others argued that if underwriters wanted to impose a warranty they should do so expressly.[11] It is clear, however, that there is no consensus on the issue. Given that the implied warranties have governed marine insurance for well over a hundred years, and that there is no great support for their removal, we propose to retain them in their current form.

16.10 **Do consultees agree that the implied marine warranties should be retained?**

6 (2011) LCCP 201/ SLCDP 152.

7 Above, paras 16.8 to 16.21.

8 See for example *Gibbs v Mercantile Mutual Insurance (Australia) Limited* [2003] HCA 39.

9 See Marine Insurance Act 1906, ss 39, 40 and 41.

10 LCCP 182/ SLCD 134, para 8.116 and following.

11 This view was expressed by Mark Wibberley of AON, Peter Franklin of JLT, BIBA and the Faculty of Advocates.

Should breach of the implied warranties suspend the insurer's liability?

16.11 We have considered whether breach of the implied marine warranties should suspend liability or should result in the automatic discharge of liability. We think that the consequences of breach of the implied warranties should be consistent with breach of express warranties, so that a breach should suspend the insurer's liability rather than discharge it.

16.12 The issue does not arise for all the implied warranties. For example, in time policies the implied term of seaworthiness is not a warranty in the true sense, but only states that the insurer is not liable for any loss attributable to unseaworthiness, if this was with "the privity of the assured".[12] In this case, the law requires a causal connection before the requirement takes effect.

16.13 The issue would however arise with the implied warranty of "portworthiness".[13] This warranty applies to voyage policies which attach while the ship is in port ("at and from" policies). If the ship encounters a problem in port, which is remedied before the ship leaves port, then on a strict construction of the 1906 Act, the insurer is not liable for any loss which occurs at sea. This seems unduly strict.

16.14 The reform would also apply to the implied warranty of seaworthiness in voyage policies. Section 39(1) of the 1906 Act states:

> In a voyage policy there is an implied warranty that at the commencement of the voyage the ship shall be seaworthy for the purpose of the particular adventure insured.

16.15 "Seaworthiness" is defined by section 39(4):

> A ship is deemed to be seaworthy when she is reasonably fit in all respects to encounter the ordinary perils of the seas of the adventure insured.

16.16 The concept is extremely wide. A ship may be unseaworthy for a range of factors, including for example, the design of the hull, the way it has been loaded, the competency and adequacy of the crew, or the lack of navigational equipment or fuel. Some breaches may be central to the risks posed by the voyage, while others may be technical.[14] In 1806, it was held that leaving port with insufficient medicines may also amount to a breach of the implied warranty, discharging the insurer from all subsequent liability.[15]

[12] Section 39(5) of the 1906 Act states: "In a time policy there is no implied warranty that the ship shall be seaworthy at any stage of the adventure, but where, with the privity of the assured, the ship is sent to sea in an unseaworthy state, the insurer is not liable for any loss attributable to unseaworthiness."

[13] Section 39(2) states: "Where the policy attaches while the ship is in port, there is also an implied warranty that she shall, at the commencement of the risk, be reasonably fit to encounter the ordinary perils of the port."

[14] *Cheikh Boutros v Ceylon Shipping Lines (The Madeleine)* [1967] 2 Lloyd's Rep 224 held that a ship may be unseaworthy because it does not carry the correct documentation.

[15] *Woolf v Claggett* (1806) 3 Esp 257.

16.17 This result may have been appropriate in 1806, when once a ship had left port it became extremely difficult to remedy the breach. We do not think that it is appropriate today, when a global economy and air transport, including helicopters, mean that many breaches may be remedied after a voyage has commenced. Where a breach has been remedied, we think liability should resume. This would encourage policyholders to remedy defects.

16.18 **Do consultees agree that where an implied marine warranty has been breached, the insurer's liability should be suspended, and resume once the breach has been remedied?**

Implied voyage conditions

16.19 There are other provisions within the 1906 Act that operate in a similar way to warranties. They are expressed as conditions precedent to the attachment of the risk. For example, section 43 states that:

> Where the place of departure is specified in the policy, and the ship instead of sailing from that place sails from any other place, the risk does not attach.

16.20 This can lead to technical arguments. For example, in *Molinos Nacionales v Pohjola Insurance Company Ltd*, the ship was meant to sail from Tallinn, but instead sailed from Muuga, an adjacent port separated from Tallinn by a headland only 3 miles across, and managed by the same port authority.[16] The difference in port had no bearing on the risk. Mr Justice Coleman described the insurer's argument that the risk did not attach as having "no merit whatsoever". However, the Act and earlier authorities permitted insurers to avoid a voyage policy for "trivial, entirely immaterial, deviations". He was therefore forced to conclude that the insurers should be allowed to defend the claim on these grounds, and were entitled to proceed to trial.

16.21 Other parts of the 1906 Act raise similar issues. Under section 44, for example, the policy does not attach if the ship sails to the wrong destination. Under sections 45 and 46, if the destination is changed or there is a deviation, the insurer is discharged.

16.22 During consultation, the implied voyage conditions received little discussion. Professor Merkin considered that they were obsolete in practice. The City of London Law Society agreed. They commented that their use was so rare that they did not affect the normal operation of policies today.

16.23 The Law Reform Committee of the Bar Council said that they were not aware of any problems caused by the implied conditions. They thought that unless there were very strong reasons for abolishing them they should be retained. Royal & Sun Alliance plc also argued for their retention.

16.24 There seems to be no call from the industry to remove the voyage conditions, and we therefore make no proposals in respect of them. They are expressed as conditions precedent to the attachment of the risk, rather than as warranties, and our proposals do not affect them.

16.25 **Do consultees agree that the voyage conditions set out in sections 42 to 49 of the Marine Insurance Act 1906 should be retained?**

REINSURANCE

16.26 Under the current law, if a policyholder breaches a warranty, then the reinsurer may refuse to indemnify the insurer even if the insurer has chosen to condone the breach.

16.27 This is illustrated by *HIH Casualty & General Insurance Ltd v New Hampshire Insurance Co.*[17] The insurers, HIH, provided cover under two policies to banks against the risk that two series of films for which they had provided funding would not produce sufficient profits to repay the loans. They then reinsured that risk. The reinsurance contract was made subject to all terms, clauses and conditions as the original insurance contracts. An insufficient number of films were made. The reinsurer declined to indemnify HIH on the basis that the requirement for six films was a warranty and it had been breached. The reinsurer succeeded in this defence even though HIH had paid the claim.

16.28 In 2007, we argued that the law of warranties in reinsurance should follow, as closely as possible, the law that governs warranties in the original insurance contract. Otherwise there is a danger that the insurer would be obliged to pay the claim but would not be entitled to reimbursement from the reinsurer. The parties should be free to contract for such an outcome if they wished, but should do so deliberately rather than inadvertently.

16.29 Most insurers agreed, arguing that it would be sensible to align reinsurance with direct insurance and that anomalies between the two could lead to confusion and unnecessary litigation.[18] A few consultees disagreed. The Liverpool Underwriters and Marine Association, for example, thought that English reinsurers may find themselves at a disadvantage compared to other jurisdictions which have a legal regime similar to that which currently operates in the UK.[19]

16.30 We do not think that reinsurers have anything to fear from our proposals, especially as they may contract out of them if they wish. We think that if a direct insurer is liable to pay a claim after the policyholder has remedied their breach of warranty, then the starting point should be that the reinsurer will reimburse the direct insurer under the terms of the contract. If the parties wish to come to another arrangement, they will be free to do so.

[16] (Unreported) High Court, 5 May 1998.

[17] [2001] EWCA Civ 735, [2001] 2 All ER (Comm) 39.

[18] This view was supported by: Aegon, Fortis Insurance Ltd, Royal & Sun Alliance, Bright Grey, Aviva, the International Underwriting Association of London, Scottish Widows, Allianz and was also supported by the Law Reform Committee of the Bar Council.

[19] In Part 13 we show that many common law jurisdictions have already moved away from the UK approach. The 1906 Act does not apply in Bermuda, however, it is thought that to the extent that the Act is declaratory of the common law, the material provisions will be applied as part of Bermudan common law; it would be open to commercial parties who wished to preserve the 1906 position to contract under Bermudan law. See further O'Neill and Woloniecki, *The Law of Reinsurance* (3rd ed 2010), paras 1-025 to 1-030.

16.31 **Do consultees agree that the default regime for breach of warranty should apply to reinsurance in the same way as it applies to direct business insurance?**

CHAPTER 3

CONCLUSION

PART 17
ASSESSING THE IMPACT OF REFORM

17.1 In this Part, we summarise the main costs and benefits of the proposed reforms. Alongside this Consultation Paper we are also publishing a full Impact Assessment of our proposals,[1] and consultees are referred to that document for further details.

DISCLOSURE: THE AIM OF THE REFORMS

17.2 The reforms set out in Chapter 1 are in two parts. First, they clarify the duty of a business policyholder to give pre-contract information to an insurer. Under the proposals, businesses should follow reasonable and proportionate procedures in discovering information. They should then make a fair presentation of the risk to the insurer. If this would prompt a reasonably careful insurer to make further enquiries, the insurers should ask appropriate questions.

17.3 The aim is to improve the quality of information businesses provide to insurers before taking out insurance. In Part 4 we highlighted endemic failures by businesses to disclose material information. We hope that legal change will encourage insurers and businesses to work together to draw up sector specific protocols and other guidance over what procedures should be followed and what information should be disclosed.

17.4 Secondly, where a business acts honestly, but nevertheless fails to disclose a material circumstance, we propose a new default regime of proportionate remedies.[2] The intention is to provide a neutral system of remedies, which give both parties an incentive to encourage good practice. We also hope that this will lead to a less adversarial approach to disputes and provide businesses with more effective insurance.

Benefits

17.5 On this basis, the benefits of the reforms would be:

(1) fewer instances of non-disclosure;

(2) reduced legal costs, both because there would be fewer disputes over non-disclosure, and those that remain would be easier to resolve;

(3) more streamlined disclosure procedures, leading to fewer administrative costs and less "data dumping";[3]

(4) more effective insurance, which is less likely to fail when a business comes to rely on it; and

[1] Available on our websites at http//www.lawcom.gov.uk (see A – Z of projects and follow the link to insurance contract law) and http//www.scotlawcom.gov.uk (see news column).

[2] The parties to a business insurance contract can contract out of the proportionate remedies subject to certain safeguards.

[3] This is where a proposer provides the insurer with a huge amount of relevant and irrelevant undigested data for the insurer to sort through.

(5) increased confidence in the UK insurance market and in UK law.

Costs

17.6 The main cost would be the one off transitional cost of adapting to the new law. The benefits will only be fully realised if insurers and businesses take time to review their current procedures and work out better ways of exchanging information. Most of the benefit would come not from the legislation itself but from industry protocols and guidance on how the legislation should be implemented in practice. The industry would need to make this investment to reap the benefits of the reforms.

The effect on the price and value of insurance

17.7 An insurer who fails to understand the full extent of the risk is likely to under-price the policy. Lacking full disclosure of material circumstances, the insurer is likely to fix a premium which is too low. Initially, the policyholder may perceive this to be a benefit, but it comes with a long-term cost. In the event of a loss, the insurer may refuse the claim on the basis of non-disclosure. The insurance, though cheap, becomes worthless.

17.8 If insurance is correctly priced, the business would pay more in premium but would receive more in claims payments. At one level, the costs and benefits to businesses cancel each other out: the money paid in premiums is returned in payments. The net benefit, however, is that where insurance works correctly by charging the correct price and paying the expected claim, the insurance has performed its purpose. Its value has increased.

17.9 The reforms would lead to greater claims payments in two ways. First, there should be less non-disclosure, leading to fewer disputed claims. Secondly, where there is a dispute, the reliance on proportionate remedies should lead to slightly higher settlements, paid for by slightly higher premiums. Businesses will benefit by securing more effective insurance. As the Construction Industry Council said in response to our previous Consultation Paper, if premiums rise "so be it; more effective insurance arrangements should come at a price".

The effect on behaviour

17.10 It is important that the law provides the right incentives to both businesses and insurers to encourage good pre-contract disclosure. At present, the law imposes a harsh penalty on business policyholders who fail to disclose a material circumstance: the insurer may avoid the contract and refuse all claims. In theory, this should act as a strong incentive on the business to disclose fully. In practice, however, the Mactavish Report reveals widespread failures to disclose.[4] Many business policyholders fail to understand the law: the duty is too general and too counter-intuitive. Few businesses believe that the law expects them to second-guess what the insurer wants to know. Even if they do believe it, they have little idea of how to set about the task.

[4] Mactavish Corporate Risk & Insurance – The Case for Placement Reform. The Mactavish Protocols at p17.

17.11 In Part 4 we argue that good disclosure requires co-operation by both parties. Businesses should make a fair presentation of the risk, but insurers should also ask appropriate questions. The current law provides insufficient incentive for insurers to indicate what they wish to know. Conversely, it encourages a passive approach, whereby an insurer may accept a risk despite an inadequate presentation, and ask questions only if a claim subsequently arises. The Mactavish Report found that senior insurers were aware of endemic failures to present risks.[5] Yet the industry as a whole has done relatively little to provide guidance on what should be in a presentation.

17.12 The aim is to provide appropriate incentives on both sides to encourage disclosure. The proposals retain strong penalties for businesses who act deliberately or recklessly. In these cases the insurer may avoid the policy and retain premiums. In other cases, the policy may still be avoided if the insurer would not have taken the risk at all. If the insurer would have charged more, the business will only receive a proportion of the claim. We do not think that this will lead to less care being taken by businesses, and it should lead to more care by insurers.

DISCLOSURE: QUANTIFYING THE EFFECTS

17.13 It is difficult to quantify the effect of the proposals. In the Impact Assessment we summarise the available evidence and make some tentative estimates. We draw on the Report prepared by PwC for the Association of British Insurers in 2007,[6] on Airmic's members' survey[7] and on research for Lord Justice Jackson's review of the costs of civil litigation.[8] We very much welcome comment on these estimates, and any evidence which consultees might have on these issues.

The volume of disputes

17.14 The duty of disclosure generates considerable litigation. We identified 41 reported judgments on the duty of disclosure in the last 10 years.[9] Of these, 38 were in England and Wales: 26 in the High Court and 12 in the Court of Appeal. The remaining three cases were in the Scottish Court of Session. These form "the tip of an iceberg". In the Impact Assessment we draw on the Judicial Statistics[10] and on Airmic's members' survey to estimate that over the last 10 years in England and Wales, there were around 4,000 disputes over non-disclosure, of which proceedings were started in between 600 and 700 cases.[11]

[5] Mactavish Corporate Risk & Insurance – The Case for Placement Reform. The Mactavish Protocols at p 17.

[6] ABI Research Paper 5. The Financial Impact of the Law Commission's Review of Insurance Contract Law. Report by PricewaterhouseCoopers; (Nov 2007).

[7] Airmic Non-disclosure of material information – Member Survey (2010).

[8] Jackson LJ, *Review of Civil Litigation Cost: Preliminary Report* (2011).

[9] Between January 2002 and January 2012.

[10] Ministry of Justice, Judicial and Court Statistics 2010 (June 2011).

[11] In any given 10 year period, some cases will have started as disputes without reaching full resolution, similarly some judgments and appeals will relate to cases started before the 10 year period.

The costs of disputes

17.15 This level of dispute generates substantial legal costs, though it is difficult to say how much. One problem with estimating the cost of legal disputes is that a few extremely expensive cases lead to very high average (mean) costs which are much larger than typical (median) costs.

17.16 Based on the research carried out for Lord Justice Jackson's review of the costs of civil litigation,[12] we have estimated total costs in England and Wales as follows:

Table 1: Estimated costs of disputes over non-disclosure in commercial insurance In England and Wales over 10 years.

Number of disputes	Average cost per case	Total costs in category (£M)
12 appeals	Additional £35,000	0.4
26 High Court judgments	£400,000	10.4
624 cases where proceedings were issued (but which did not proceed to trial)	£100,000	62.4
6,350 disputes where no proceedings were issued	£25,000	158.8
TOTAL costs for policyholders		232.0
TOTAL costs for insurers (assuming similar levels)		232.0
OVERALL TOTAL for both parties over 10 years		464.0
Costs per year		**46.4**

17.17 We have not been able to find separate figures on the costs of cases before the Scottish courts but these are unlikely to be high.[13]

17.18 On this basis we have estimated that legal fees in dealing with disputes over non-disclosure may cost the UK economy up to £50 million a year. We welcome views on this broad estimate.

[12] Jackson LJ, *Review of Civil Litigation Costs: Preliminary Report* (2011).

[13] The Report of the Taylor Review of Expenses and Funding in Civil Litigation in Scotland (scheduled for the end of 2012) might provide useful material in this regard.

17.19 In addition to legal fees, policyholders and insurers also incur internal costs in dealing with disputes, both in terms of staff time and in disruption to the business. We welcome evidence from both businesses and insurers on the amount of additional costs imposed by any dispute with which they have been involved.

17.20 **We invite comments on the view that legal fees on non-disclosure disputes cost the UK economy up to £50 million a year.**

17.21 **We welcome information on the scale of legal fees associated with disputes over non-disclosure in commercial insurance in the Scottish courts.**

17.22 **What additional costs are associated with each dispute, in terms of staff time and disruption to both policyholders and insurers?**

The administrative costs of exchanging information

17.23 We recognise that insurance provides cost-effective access to capital when a business suffers loss. Compared with other forms of capital, the administrative costs of arranging insurance are low. We wish to preserve this.

17.24 At present, many of the costs of arranging insurance are the internal costs of preparing a presentation of the risk. In Airmic's member survey, 75% of firms that responded spend between two and six months each year in preparing the information they submit to insurers.

17.25 We have received anecdotal evidence that businesses respond to the apparent harshness of the current law by "data dumping" – by overwhelming the insurer with CDs full of irrelevant and undigested information. We have not been able to quantify the wasted costs of "data dumping", though it has the potential to be considerable. It wastes the business's time in preparing it, and the insurer's time in reading it.

17.26 Under the proposals, insurers are required to read and consider the presentation before entering into the contract, and ask appropriate questions. We have considered whether this will involve additional costs. It may increase costs for the small minority of insurers who do not currently consider presentations adequately, but we do not think it will increase costs for competent insurers. Again, we welcome views.

17.27 **Have consultees encountered instances of "data dumping", whereby businesses disclose large quantities of irrelevant information? If so, what costs are wasted by this practice?**

17.28 **Would the costs of presenting a risk be reduced by greater clarification of what information should be included?**

17.29 **Would insurers incur additional costs by considering presentations and asking appropriate questions before entering into contracts?**

Claims payments

17.30 Claims rejection can lead to catastrophic consequences for the firm involved. The Mactavish Report comments that many businesses would not be able to borrow money following a serious loss in the absence of an insurance payment.

17.31 At present outright rejections appear rare. Many claims are paid as a matter of goodwill. There was concern, however, that such goodwill may be running out. As the long soft insurance market turns hard, insurers may be much more prepared to rely on their strict legal rights to refuse claims, even in the absence of wrongdoing. Without the expected claims payment, the firm may not be able to resume trading, leading to insolvency. This would have potentially serious consequences, not just for shareholders but also for employees, creditors and the economy as a whole.

How many claims are rejected for reasons of non-disclosure?

17.32 In November 2007, the PwC Report explained that larger claims were most likely to be declined as insurers investigate these more closely.[14] Any estimate of the value of rejected claims was difficult, as the amounts would fluctuate. PwC's tentative estimates are set out in the table below.

Table 2: PwC's estimate of the annual value of claims in commercial insurance where whole claim rejected for reasons of non-disclosure.[15]

	Commercial property	Marine insurance
% of claims by value	2 to 4%	1 to 2%
Total value of rejected claims each year	£70m to £140m	£4m to £8m

17.33 Subsequent consultation suggests that these figures may be over-estimates. The Mactavish Report found that outright rejections are rare.[16] This was confirmed by our own consultations with insurers. There was agreement that commercial property insurance was the sector most affected by non-disclosure, and that it was possible that issues of non-disclosure arise in around 4% of the cases. It was argued, however, that in the majority of non-disclosure disputes, a settlement was eventually reached.

17.34 Estimates of the value of rejected claims are extremely difficult to make. We tentatively suggest that for commercial property insurance non-disclosure is raised in around 4% of claims by value: in 3% of claims a settlement is reached, while 1% of claims are rejected. We welcome views on this figure. For other areas of insurance, the issue of non-disclosure appears less important.

[14] PwC Report p 103.

[15] PwC Report p 103.

[16] The Airmic study found that 5% of firms had litigated over non-disclosure in the last 5 years, or 1% per year.

17.35 **In commercial property insurance, how many claims are rejected for non-disclosure? We welcome views on the tentative estimate that non-disclosure issues are raised in 4% of claims by value, of which 1% lead to outright rejection and 3% are settled**.

The effect of the proportionate remedies

17.36 In Part 9 we proposed a default regime of proportionate remedies. At present, these are not recognised at law, but may be applied in practice. Most disputes settle, and the settlement often reflects the seriousness and consequences of the non-disclosure. Proportionate remedies are intended to allow those settlements to be reached more quickly, as the parties "cut to the chase" of the amount of payment, rather than exchanging denials that any wrongdoing took place, or that any sum is due.

17.37 By depriving insurers of the "nuclear option" to deny the whole claim, proportionate remedies would also lead to more balanced negotiations, leading to somewhat higher settlements. As one lawyer put it:

> Instead of going into negotiations saying we are paying nothing and end up paying half, we would say we would pay a third and end up paying two thirds.[17]

17.38 We have modelled the effect of the reforms on claims payment in commercial non-disclosure cases in the following tables. These models and estimates are set out in the Impact Assessment.

17.39 The greatest effect is likely to be in commercial property insurance. The models suggest that the reforms could increase claims payments by 0.36%, which would be passed on to policyholders in increased premiums. In other words, for every £100 of premium paid for commercial property insurance, buyers would pay an additional 36p.

17.40 This would be both a cost to policyholders when buying insurance, and a benefit to policyholders when submitting claims. The payment itself is therefore neutral in cost-benefit terms. The overall benefit of the reforms lies in the added value given to the insurance: it is more likely to be effective when it is needed.

17.41 If policyholders wish to save 0.36% on their premiums, the proposals allow the parties to contract out of proportionate remedies. It may be more rational, however, for a business to increase the excess on smaller and affordable losses, rather than take the risk that the insurance will fail completely when it is most needed.

DISCLOSURE: CONCLUSION

17.42 In the Impact Assessment we summarise the costs and benefits as follows.

[17] Insurance Contract Law: Misrepresentation and Non-Disclosure (Sept 2006) at para 7.22.

Transitional costs

17.43 The proposals are designed to encourage both insurers and insurance buyers to review the way that information is exchanged and work together to produce improvements. One aim is to encourage industry protocols on what amounts to "the key material facts" for different types of risk. This would be combined with training for both underwriters and insurance managers in the new law. The transitional costs of implementing the reforms to the law of non-disclosure and misrepresentation in consumer insurance were estimated at between £1 million and £1.5 million, and we think the costs of this reform may be of a similar order of magnitude. We tentatively estimate transitional costs of between £1 million and £2 million.

17.44 **We seek views from insurers and businesses about how much it might cost to review processes, develop protocols and train staff to adjust to the proposed reforms.**

Annual costs

17.45 We do not anticipate that the reforms will result in on-going costs. As discussed above, the reforms may lead to more claims being paid, which would be paid for by increased premiums. This is both a benefit to policyholders (in additional claims payment) and a cost to policyholders (in increased premiums). The overall effect is neutral.

Transitional benefits

17.46 We do not anticipate any transitional benefits.

Annual benefits

17.47 We anticipate four benefits from the proposals: fewer disputes; administrative savings; more effective insurance; and more confidence in the UK insurance market. We look at each in turn.

Fewer disputes

17.48 Earlier we estimated that non-disclosure disputes cost up to £50 million a year in legal fees. The reforms are designed to clarify the duties so as to prevent non-disclosures, and to make it easier to resolve issues if they arise.

17.49 If non-disclosure disputes were reduced by 25%, this would lead to savings of £12.5 million. If the remaining disputes were 20% less expensive to resolve, the savings would be £7.5 million. This would suggest the possibility of savings of up to £20 million a year. To err on the side of caution, however, it may be more realistic to suggest a range of between £10 million and £20 million.

17.50 In addition, there would be non-quantified benefits in terms of reduced delay and fewer internal expenses.

17.51 **We invite comments on the estimate that the reforms would reduce legal costs for both insurers and businesses by between £10 million and £20 million a year.**

Administrative savings

17.52 At present, large businesses devote substantial resources to preparing presentations. The proposals aim to make the process more streamlined, so that less unnecessary information is included. We think that this should lead to administrative savings for business policyholders, but we have not been able to quantify these.

More effective insurance

17.53 Where claims are disputed, the effect on the business may be much more serious than the legal and administrative fees involved. Delay in paying the claim may delay the recovery programme, leading to unnecessary business interruption.

17.54 In serious cases, prolonged delay or outright rejection may lead to the business failing completely, with knock on consequences for employees who are made redundant, creditors who are unpaid, and the wider economy. Even the failure of one mid-range company, with a turnover of around £100 million, could have serious repercussions on a local economy. There may also be implications for the public purse in terms of redundancy and social security payments to employees, and for public sector creditors such as HM revenue and Customs.

17.55 **We welcome views on the effect of the delay or rejection of an insurance claim for reasons of non-disclosure for the business, employees, creditors and the wider economy.**

Improved confidence in UK law

17.56 Finally, the reforms aim to improve confidence in the UK insurance market and in UK law which underpins it.

17.57 As discussed in Part 3, many other jurisdictions impose a less onerous duty of disclosure than UK law. For example, under New York law, the insurer may only avoid a policy for a misrepresentation or for “wilful concealment”. Another approach to disclosure is that taken by the Principles of European Insurance Contract Law (PEICL) which do not recognise a duty to disclose in the absence of questions.

17.58 In a world of global finance, the UK increasingly has to justify differences in commercial law between the UK and its European partners.[18] UK insurance law has many strengths but, as we argued in our 2011 Consultation Paper, there are areas where UK law is so confused or outdated that it is difficult to justify to an international audience. We therefore think that it would be timely to reform those areas of insurance law that are considered to be particularly problematic. This should encourage international policyholders to use UK law, with benefits for UK lawyers and UK courts.

WARRANTIES

17.59 The Impact Assessment concentrates on the reforms to the duty of disclosure as this is where we anticipate the greatest impacts. By comparison, the reforms to the law of warranties will have less effect.

17.60 The proposals outlined in Chapter 2 are cautious. They prevent an insurer from refusing a claim for breach of a warranty where the breach has already been remedied, or where the term was designed to cover other sorts of loss. In 2007 PwC identified costs associated with a causal connection test for breach of warranty, but we are not proceeding with this proposal.[19]

17.61 We have been told by consultees that it is rare for an insurer to try to refuse a claim for a breach of a warranty which has already been remedied. It is also rare for an insurer to seek to refuse a claim for one type of loss, when the warranty or condition was aimed at a different type of loss. Insurers are most likely to run such arguments where they wish to reject the claim for another underlying reason. An example is *Sugar Hut v Great Lakes Reinsurance (UK) Plc,* discussed in Part 12.[20] Here one of the arguments put forward by the insurer was that the claim for fire damage should be refused because the policyholder had installed the wrong sort of burglar alarm.

17.62 The reforms aim to reduce legal costs in two ways:

(1) The courts have attempted to moderate the harshness of the current law by interpreting a warranty narrowly, or by identifying it as being something other than a warranty. As explained in Part 12, this has introduced uncertainty and inconsistency into the law. This means that it is difficult to predict the outcome of particular case and give appropriate advice for its resolution.

(2) The current law encourages insurers to extend the cost of disputes by adding poor additional arguments to their defences.

[18] In 2009, the European Commission identified insurance law as one area where common rules should be considered: see Communication from the Commission to the European Parliament and the Council, "An Area of Freedom, Security and Justice serving the Citizen" (10 June 2009) (COM (2009) 262 Final), at para 3.4.2. In September 2011, the EU Justice Commissioner, Viviane Reding, stated that the European Commission wants to start a dialogue with the insurance sector about the possible added value of an optional European Insurance Contract Law, see memo 11/625 at http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/624&format=HTML&aged=0&language=EN&guiLanguage=en.

[19] The PwC Report at p 6.

[20] [2010] EWCA 2636 and see Part 12, para 12.51 and following.

17.63 In addition, the reforms are designed to increase confidence in UK law. As we have seen, the current law of warranties is out-of-line with international developments, and difficult to explain to an international audience. This may encourage some policyholders to reject UK law in favour of another legal system.

17.64 The only identified cost is the one-off transitional costs of familiarisation: lawyers, advisers and members of the industry will incur the cost of becoming familiar with our proposals. The proposed changes to the law of warranties can be contractually excluded, so some insurers may wish to consider whether to redraft contract terms. We doubt, however, that many insurers would wish to refuse claims for breaches of warranties which have already been remedied, or for breaches of terms designed to cover other losses.

17.65 We think, therefore, that the warranty reforms we propose will have a limited, but beneficial impact.

17.66 **Do consultees agree that the proposed reform of the law of warranties will result in:**

(1) small savings in legal costs; and

(2) increased confidence in UK law?

PART 18
LIST OF PROPOSALS AND QUESTIONS

18.1 We ask for comments and responses to the following questions:

THE DUTY OF DISCLOSURE AND MISREPRESENTATION

The need for reform

18.2 Do consultees agree that there is a need to reform sections 18 to 20 of the Marine Insurance Act 1906 to clarify the duty of disclosure in business insurance? (4.83)

Small and large businesses

18.3 Do consultees agree that the same legal regime should apply to all businesses, both large and small? If consultees think that special protections should apply to smaller businesses, please provide evidence of need. (4.86)

Clarify the duty of disclosure

18.4 Do consultees agree that:

(1) the essential elements of section 18(1) of the Marine Insurance Act 1906 should be retained, so that before entering into an insurance contract, a business policyholder should disclose every material circumstance which it knows or ought to know; but

(2) that the concepts of material circumstance and knowledge should be clarified in legislation? (5.78)

A fair presentation of the risk

18.5 In particular, should legislation specify that:

(1) a material circumstance is a circumstance required to provide a fair presentation of the risk?

(2) A fair presentation of the risk should include;

(a) Any unusual or special circumstances which increase the risk;

(b) Any particular concerns about the risk which led the policyholder to seek insurance;

(c) Standard information which market participants generally understand should be disclosed?

(3) Where the insurer receives information which would prompt a reasonably careful insurer to make further enquiries, an insurer who fails to make appropriate enquiries should not have a remedy for non-disclosure of any fact which those enquires would have revealed? (5.79)

18.6 Do consultees agree that these principles would encourage insurers and policyholders to work together to improve pre-contract disclosure? (5.80)

18.7 Do consultees agree that other aspects of the doctrine of waiver can be left to the courts? (5.81)

Writing the inducement test into legislation

18.8 Do consultees agree that:

(1) If sections 18 to 20 of the Marine Insurance Act 1906 are to be amended the opportunity should be taken to include the inducement test within the statute?

(2) The statute should provide that to obtain a remedy for non-disclosure or misrepresentation, the insurer must show that without the non-disclosure or misrepresentation it would not have entered into the contract at all, or would have done so only on different terms? (5.84)

The policyholder's knowledge: section 18

18.9 Do consultees agree that:

(1) For the purposes of deciding what a business policyholder should disclose to an insurer before concluding an insurance contract, the issue of what constitutes knowledge should be clarified in legislation?

(2) Where a business policyholder is a corporate entity, "knowledge" should include information known to:

(a) The directing mind and will of the organisation; and

(b) The persons who arranged the insurance on behalf of the organisation?

(3) For these purposes "knowledge" should mean:

(a) Actual knowledge; and

(b) "Blind eye" knowledge?

(4) A business policyholder should also be under a duty to disclose information that would have been discovered by reasonable enquiries, which are proportionate to the type of insurance and to the size, nature and complexity of the business? (6.78)

The policyholder's knowledge: section 20

18.10 Do consultees agree that:

(1) Rather than distinguish between "matters of fact" and "matters of expectation or belief", section 20 of the 1906 Act should be amended to distinguish between matters which the policyholder knew or ought to know about (as previously defined) and other matters?

(2) Where the representation is one which the policyholder knew or ought to know about, it must be true?

(3) Where the representation is not one which the policyholder knew or ought to know about, it must be made in good faith? (6.95)

The broker's knowledge: section 19

18.11 Do consultees agree that:

(1) There is a need to clarify the scope and nature of section 19(a) of the Marine Insurance Act 1906?

(2) The amended section 19(a) should:

(a) apply to producing, placing and intermediate brokers?

(b) be confined to information received or held by that agent in its capacity as agent for the policyholder?

(c) include information which the broker actually received in its capacity as agent for the policyholder, together with information which the broker deliberately avoided acquiring?

(3) Where the broker is involved in carrying out reasonable enquiries on behalf of the business policyholder, the insurer should have a remedy against a policyholder if the broker fails to disclose information which it would have discovered by those reasonable enquiries?

(4) Section 19(b) should be repealed? We welcome views on whether there are any reasons to preserve this section. (7.78)

The insurer's knowledge: section 18(3)(b)

18.12 Do consultees agree that, in the absence of inquiry, a business policyholder need not disclose:

(1) Matters of common knowledge?

(2) Information relating to the practices and risks of the trade which a well-informed insurer writing that particular class of business ought to know?

(3) Information which is already known to:

(a) The directing mind and will of the insurers; or to

(b) The persons who make the underwriting decision?

(4) Information held by the insurer's agent or employee which ought to have been communicated to the person making the underwriting decision? (8.50)

Proportionate remedies

18.13 Do consultees agree that, where the policyholder's conduct is not dishonest, proportionate remedies should be the default regime for non-disclosure and misrepresentation in business insurance? (9.39)

18.14 Do consultees agree that the remedy should focus on the contract that the insurer would have entered into with the policyholder if the policyholder had fully complied with its duty of disclosure? In particular:

(1) If the insurer would not have entered into the insurance contract at all, the insurer may avoid the contract?

(2) If the insurer would have entered into the contract on different terms (excluding the premium), the contract is to be treated as if it included those terms?

(3) If the insurer would have charged a higher premium, the insurer may reduce proportionately the amount to be paid on a claim (which may be additional to the inclusion of other terms)? (9.40)

The effect on reinsurance

18.15 Do consultees agree that the effect of a proportionate remedy on reinsurance can be left to freedom of contract between insurers and reinsurers? (9.53)

A right to cancel on reasonable notice

18.16 Where an insurer is entitled to apply a proportionate remedy to a claim, should the statute provide that:

(1) the insurer has the right to cancel on reasonable notice; and

(2) the policyholder has the right to cancel on reasonable notice? (9.62)

Dishonest conduct

18.17 Do consultees think that the statute should provide a specific definition of "deliberate or reckless" non-disclosure and misrepresentation? Alternatively, should the statute refer to fraudulent conduct and leave this to the courts to define in accordance with the existing law? (9.74)

18.18 If deliberate or reckless conduct should be defined, should it be defined as conduct where the proposer:

(1) had actual knowledge of the relevant facts (or shut its eyes to the relevant facts), and

(2) (in the case of omissions) knew that the facts were relevant to the insurer, or did not care whether or not they were relevant to the insurer? (9.75)

18.19 Where the proposer has behaved deliberately or recklessly, do consultees agree that the insurer should be entitled to:

(1) avoid the policy and refuse all claims; and

(2) keep any premium paid? (9.76)

Contracting out

18.20 Do consultees agree that:

(1) The parties to a business insurance contract should be entitled to contract out of the proportionate remedies for non-disclosure and misrepresentation in favour of the insurer through a contract term; but

(2) that such a term is only effective if it is written in clear, unambiguous language and specifically brought to the attention of the other party before the contract is formed? (9.85)

The duty of good faith

18.21 Do consultees agree that the duty of good faith should continue as an interpretative principle, but should not in itself give either party a cause of action? (10.22)

18.22 Should section 17 refer to "utmost good faith" or simply "good faith"? (10.27)

WARRANTIES

Abolishing basis of the contract clauses

18.23 Do consultees agree that, in business insurance, a term in a proposal form, contract or accompanying document which states that the policyholder warrants the accuracy of the answers given or that the answers form the basis of the contract should be of no effect? (15.13)

Warranties and the suspension of liability

18.24 Do consultees agree that where a warranty is not complied with:

(1) the insurer's liability should be suspended; and

(2) liability should be restored where the policyholder remedies the breach? (15.25)

Excused non-compliance and waiver

18.25 Do consultees agree that sections 34(1) and 34(3) of the Marine Insurance Act 1906 should be retained? (15.30)

Should insurers be given a statutory right to cancel?

18.26 Do consultees agree that where the policyholder breaches a warranty, the insurer's right to cancel the contract should be contractual rather than statutory, and therefore governed by the terms of the contract? (15.34)

Terms to reduce particular risks

18.27 Do consultees agree that:

(1) Where a term is included to reduce the risk of a particular type of loss, then in the event of a breach of the term, the insurer's liability should be suspended only in respect of that type of loss?

(2) Where a term is included to reduce the risk of a loss at a particular time or in a particular location, then in the event of breach of the term, liability would be suspended only in relation to losses at that time or at that location? (15.53)

Contracting out

18.28 Do consultees agree that:

(1) In consumer insurance, a term which purports to put the consumer into a worse position as regards breach of warranty than that set out in the proposed reform should be of no effect?

(2) In business insurance, a term which permits an insurer to refuse a claim

(a) for a breach of warranty which was remedied before the loss; or

(b) for breach of a term designed to reduce the risk of another type of loss (or loss at a different time or place)

is only effective if it is written in clear, unambiguous language and specifically brought to the attention of the other party before the contract is formed? (15.59)

The requirement for writing

18.29 Do consultees agree that an express requirement that, in order to take effect, a warranty must be in writing is not necessary? (15.67)

Marine insurance

18.30 Do consultees agree that the rules outlined above should apply to express warranties in marine insurance? (16.5)

18.31 Do consultees agree that the implied marine warranties should be retained? (16.10)

18.32 Do consultees agree that where an implied marine warranty has been breached, the insurer's liability should be suspended, and resume once the breach has been remedied? (16.18)

18.33 Do consultees agree that the voyage conditions set out in sections 42 to 49 of the Marine Insurance Act 1906 should be retained? (16.25)

Reinsurance

18.34 Do consultees agree that the default regime for breach of warranty should apply to reinsurance in the same way as it applies to direct business insurance? (16.31)

ASSESSING THE IMPACT OF REFORM

Disclosure: quantifying the effects

18.35 We invite comments on the view that legal fees on non-disclosure disputes cost the UK economy up to £50 million a year. (17.20)

18.36 We welcome information on the scale of legal fees associated with disputes over non-disclosure in commercial insurance in the Scottish courts. (17.21)

18.37 What additional costs are associated with each dispute, in terms of staff time and disruption to both policyholders and insurers? (17.22)

The administrative costs of exchanging information

18.38 Have consultees encountered instances of "data dumping", whereby businesses disclose large quantities of irrelevant information? If so, what costs are wasted by this practice? (17.27)

18.39 Would the costs of presenting a risk be reduced by greater clarification of what information should be included? (17.28)

18.40 Would insurers incur additional costs by considering presentations and asking appropriate questions before entering into contracts? (17.29)

Claims payments

18.41 In commercial property insurance, how many claims are rejected for non-disclosure? We welcome views on the tentative estimate that non-disclosure issues are raised in 4% of claims by value, of which 1% lead to outright rejection and 3% are settled. (17.35)

Transitional costs

18.42 We seek views from insurers and businesses about how much it might cost to review processes, develop protocols and train staff to adjust to the proposed reforms. (17.44)

Annual benefits

Fewer disputes

18.43 We invite comments on the estimate that the reforms would reduce legal costs for both insurers and businesses by between £10 million and £20 million a year. (17.51)

More effective insurance

18.44 We welcome views on the effect of the delay or rejection of an insurance claim for reasons of non-disclosure for the business, employees, creditors and the wider economy. (17.55)

Warranties

18.45 Do consultees agree that the proposed reform of the law of warranties will result in:

(1) Small savings in legal costs; and

(2) Increased confidence in UK law? (17.66)

APPENDIX A
DO MICRO-BUSINESSES NEED ADDITIONAL PROTECTION?

A.1 In this Appendix we explain why we have decided not to provide additional protection to micro-businesses. Instead, we propose to include them in the general regime for non-disclosure and misrepresentation in business insurance.

A.2 We have consulted widely on this issue. In the 2007 Consultation Paper we asked whether small businesses needed more protection. Then in 2009 we published Issues Paper 5[1] which provisionally proposed that micro-businesses should be treated in the same way as consumers. Since then we have held further discussions with insurers, brokers, small business groups and the Financial Ombudsman Service (FOS).

A.3 We have concluded that special protection is not justified. We say this for four reasons:

(1) Any definition of a micro-business is likely to be arbitrary and complex. It would be difficult to apply in a routine way at the time the insurance is placed, and may not exclude particularly sophisticated policyholders, such as special purpose vehicles (SPVs) engaged in complex financial transactions.[2]

(2) Providing a third legal regime to protect small businesses would involve administrative costs. At the very least, there would be costs in asking additional questions about business size. These would only be justified if there was compelling evidence of need.

(3) Our investigations have not found evidence that the law of disclosure is a substantial problem for small businesses. In a survey, over half of brokers said that they had not encountered a problem in the last two years.

(4) In cases of hardship, the FOS is already able to provide protection to micro-businesses.

A.4 We start below by outlining the proposals we made in 2007 and 2009. We then consider each of the four reasons in detail, drawing on our consultations and research. Finally we explain why we are not proceeding with our original proposals to enact new rules to determine whether an intermediary acts for the policyholder or for the insurer.

[1] Issues Paper 5, Micro-businesses – should micro-businesses be treated like consumers for the purposes of pre-contractual information and unfair terms? (April 2009).

[2] A special purpose vehicle (SPV) or special purpose entity (SPE) is a company that is created solely for a particular financial transaction or series of transactions.

THE 2007 CONSULTATION PAPER

A.5 In 2007, we said that many small businesses are in a similar position to consumers. Most are "one person bands" without employees, which are no more likely than the average consumer to understand the duty of disclosure. As Lord Justice Longmore put it in 2001:

> How can it be right that a lawyer insuring his home and household possessions can rely on the more relaxed test of non-disclosure under the Statements of Practice, but the small trader, e.g. the garage owner or the fishmonger insuring his premises, cannot?[3]

A.6 We expressed concern, however, that it would be hard to define a small business in a way which was neither over-inclusive nor arbitrary. We provisionally concluded that small businesses would be adequately protected by the "reasonable insured" test we proposed for businesses generally, but welcomed views on the issue.

A.7 We received a mixed response. Endsleigh Insurance were among those favouring greater protection:

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

A.8 On the other hand Eversheds commented:

> It would be difficult to define small business and we do not necessarily believe that small businesses should be subject to any different protection from large businesses.

ISSUES PAPER 5: MICRO-BUSINESSES

A.9 In Issues Paper 5, we provisionally proposed additional protection for the smallest businesses, "micro-businesses", defined as any business with fewer than 10 employees.

A.10 We provisionally proposed that micro-businesses should be treated in the same way as consumers for the purposes of pre-contact information. In other words, they would not be required to volunteer information to the insurer. Instead, their duty would be to answer the insurer's questions honestly and reasonably. In all 17 consultees replied to this proposal, of whom 10 agreed. A further 25 individual businesses responded to a questionnaire on the Small Firms Consultation Database, of whom 19 favoured increased protection.

[3] An Insurance Contracts Act for a new Century? Pat Saxton Memorial Lecture, 5 March 2001 (set out in Appendix A of BILA, Insurance Contract Law Reform (2002)) para 42.

A.11 We also asked whether the provisions of the Unfair Terms in Consumer Contracts Regulations 1999 (UTCCRs) should be extended to micro-businesses. We received 15 replies, of which 8 favoured the extension, 5 opposed it and 2 did not express a preference either way.

A.12 In November 2009 we published a summary of the responses we received.[4]

Abolishing the duty of micro-businesses to volunteer information

Arguments in favour

A.13 The main argument for treating micro-businesses as consumers was that the duty of disclosure was inappropriate for small businesses. As a representative of a small communications company put it:

> I am shocked to learn that we are supposed to volunteer information that the insurers consider relevant, and failure to do so could result in a rejected claim. How can this be fair?

A.14 The International Underwriting Association of London also favoured treating small businesses differently, so that the rest of business insurance law could focus on the relationship between equal parties:

> Moving micro-businesses within the remit of consumer insurance should also have the benefit of allowing the Law Commission to be more focussed on the genuine business to business insurance relationships and not on the parties having an inequality in their negotiating position when purchasing insurance.

Arguments against

A.15 Five arguments were put against reform. It was said that any distinction would be arbitrary; that the risks incurred by micro-businesses were too diverse to be the subject of standard questions; that micro-businesses should take advice from a broker if they were unsure of the law; there are concerns about creating a third category and furthermore the Financial Ombudsman Service (FOS) could resolve unfairness in the current regime.

A.16 The Association of British Insurers (ABI) commented:

> We believe that any attempt to distinguish between businesses on the basis of size would be arbitrary and overly complex.

A.17 Aviva noted that the risks carried by micro-businesses were much more diverse and complex than those carried by consumers:

> While we agree that micro businesses are generally not sophisticated buyers of insurance, the fact remains that they are not personal consumers. By their very nature, they are carrying on commercial enterprise of different types and sizes with different risk profiles.

[4] A summary of responses to Issues Paper 5: Micro-businesses (November 2009).

A.18 In further discussions we were given an example. A micro-business manufactured plastic pipettes, which are small laboratory tubes used to measure liquid. The manufacturing process was simple and easily manageable by one person. Further enquiry revealed however that the pipettes were supplied to *in vitro* fertilisation facilities, where liability claims had the potential to be dramatic.

A.19 We were told that small businesses could use brokers to advise them. This point was put in an article by lawyers at Beachcroft for Post Magazine:

> It is not suggested that [micro-businesses'] lack of sophistication avoids any need to appoint accountants to deal with tax issues and lawyers to provide advice on contracts, so why should they not use a broker to advise on insurance issues to make sure cover matches the risk being run and the premium quoted is competitive?[5]

A.20 Finally, there were concerns about creating a "third category" for small businesses. For example, the FSA thought there might be knock on effects for other aspects of insurance law and regulation:

> … if a definition of "micro-business" for the purpose of pre-contractual information were to be introduced under the general law, this would cause tension within our regulatory rules. There could be uncertainty amongst providers and intermediaries where ICOBS also sets standards for pre-contractual documentation on firms that sell insurance.

Extending the UTCCRs

A.21 The UTCCRs give consumers protection against unfair terms in two ways. First, all terms must be in plain and intelligible language. Secondly, some terms can be assessed for fairness. Terms found to be unfair cannot be enforced against a consumer.

A.22 Many consultees were concerned that extension of the UTCCRs would lead to uncertainty. Aviva commented:

> We do not believe UTCCR should be extended to micro-businesses for the purposes of insurance contracts. Our principle [sic] concern here is one of uncertainty as to what constitutes an unfair term (and in particular what constitutes a non-core term) where the insurer is a commercial enterprise as opposed to an individual consumer. We acknowledge the point made by the Law Commissions that the standards within the UTCCR can be applied inconsistently in practice and we are therefore concerned about legislating the extension of such standards for commercial entities.

[5] The micro scope, *Post Magazine* [30 April 2009] at p 14.

A.23 Some felt that it was anomalous for micro-businesses to be granted protection by the UTCCRs when they entered insurance contracts but not when they entered other financial contracts, for example banking agreements. Insurance is, however, already in a unique position as other contracts are covered by the Unfair Contract Terms Act 1977, which does not apply to insurance.[6]

A.24 It was suggested that the matter was best left to the FOS, who could decide cases according to what was fair and reasonable, rather than being constrained by the technicalities of the law. Aviva also commented on FOS:

> One of the benefits of the FOS complaints regime is that the decisions are not constrained by precedent, but what is fair and reasonable in the given circumstances.

A.25 In their response FOS explained their position:

> We are neutral on the question of extending the ambit of Unfair Terms in Consumer Contracts Regulations to cover insurance contracts with micro-businesses. We do not apply these regulations to those commercial policyholders who presently fall within our jurisdiction, but we still feel that we are able to reach decisions that prevent insurers taking advantage of onerous provisions in their standard term policies where we believe that it would be unfair and unreasonable to do so.

Conclusion

A.26 We accept that the application of the UTCCRs is uncertain.[7] Taking account of these arguments and the problems of defining micro-businesses (discussed further below), we are persuaded not to make any further proposals on this issue.

A.27 As for the duty of disclosure, following Issues Paper 5, we conducted further research and discussions on this topic. We have come to the conclusion that the problems of definition are considerable. Furthermore, contrary to our previous expectations, we found little evidence that the law of non-disclosure and misrepresentation is a particular problem for micro-businesses. In fact, it would appear to be more of a problem for larger businesses.[8] We outline our thinking below.

PROBLEMS OF DEFINITION

Responses to Issues Paper 5

A.28 In Issues Paper 5, we proposed three options for defining micro-businesses and asked consultees which was the most practical. We considered defining a micro-business:

(1) by turnover;

[6] Unfair Contract Terms Act 1977, Sch 1, s 1.

[7] We are considering the definition of an exempt term under the UTCCRs under a different project: Unfair Terms in Consumer Contracts and see our webpage for further details.

[8] See Part 4, para 4.19 and following.

(2) by number of employees; or

(3) by tying the definition to the FOS jurisdiction limit.

A.29 Neither the turnover test nor the employee headcount test received much support. Only three consultees favoured the turnover test, while no consultees favoured the employee test. Several consultees opposed these tests for being too crude to prevent small but sophisticated businesses from falling within the definition of micro-businesses.

A.30 The Association of British Insurers (ABI) explained:

> An employee test alone is too simplistic and, therefore, insufficient.
>
> Having few employees is not necessarily a qualification for a business to receive consumer status. A firm with few employees could have a high level of sophistication (eg boutique fund managers, firms of niche solicitors and insurance brokers). Therefore if the test for a micro-business was based on number of employees alone it would mean that some sophisticated businesses would be treated as consumers, which again would go against the stated purposes of the Commissions' proposals.

A.31 Twelve consultees (80%) favoured the third option of aligning our definition of a micro-business with that of the FOS. They emphasized that it was important for there to be "symmetry" between the law and the FOS rules and standards, and that it was both sensible and logical to bring the law and FOS jurisdiction limit into line.

A.32 The Institute of Insurance Brokers argued that this would be necessary to avoid excessive confusion between conflicting layers of regulation:

> It seems a sensible option, if change is essential, to align the law and the regulatory arrangements (FSA/FOS). Otherwise there might be a great deal of confusion for business customers and insurers in the event of a dispute.

The FOS definition

A.33 The FOS is able to hear complaints from micro-businesses which fall within its rules. Its current rules came into effect on 1 November 2009 as a result of the implementation of the Payment Services Directive (PSD). The PSD adopts the general European definition of a micro-enterprise, as set out in the European Commission's Recommendation 2003/361/EC.[9] This includes businesses with fewer than 10 employees and a turnover or annual balance sheet of less than 2 million euros. The test also depends on whether the business is autonomous or a partner or linked enterprise.

[9] Notified under document number c (2003)1422.

A.34 The FOS applies this test at the time the complaint is made. Following a catastrophe (such as a fire or flood), a business may reduce considerably in both turnover and employee numbers. If the insurer then refuses its claim, the business may qualify under the FOS test when it makes its complaint, even if the business would not have qualified when it took out the insurance. The FOS can use its discretion to decide whether the business is sophisticated or unsophisticated. Only unsophisticated businesses are treated in the same way as consumers.

A.35 For our purposes the definition would need to be applied when the insurance contract was formed. Both insurers and policyholders need to know whether there is a duty of disclosure at the time that disclosure would need to be made. We think the FOS definition is too complicated to be applied at this stage. Below we list the complexities of the FOS test.

The employee requirement

A.36 The first limb states that a micro-business must have fewer than 10 employees. The European Commission's User Guide on the SME definition explains that the staff headcount covers full-time, part-time and seasonal staff.

A.37 The definition of "employee" falls to national labour rules. It includes everyone considered to be an employee according to member state law, and owner-managers and partners engaged in a regular activity in the enterprise. It does not include apprentices or students engaged in vocational training contracts.

A.38 The staff headcount is to be calculated in terms of annual work units (AWUs) for the business' financial year. Anyone who worked full-time during the entire reference year counts as one unit. Part-time staff, seasonal workers and those who did not work for the entire reference year are treated as fractions of a unit. For businesses with part-time or seasonal workers, this may involve some complex calculations.

Annual turnover and balance sheet requirements

A.39 While the employee component of the test is compulsory, a business can choose to meet either the turnover or balance sheet component.

(1) The annual turnover is determined by calculating the income the enterprise received during the year, not including VAT or other indirect taxes.

(2) The annual balance sheet total refers to the value of the company's main assets.

A.40 In calculating these amounts, businesses should use data from their last annual accounts. There are three problems with this, which we discuss below.

CURRENCY CONVERSION

A.41 First, expressing annual turnover and balance sheet requirements in euros rather than sterling means that the status of an enterprise may be susceptible to currency fluctuations.

A.42 A difficulty arises in fixing the point in time that the conversion to euros should take place. Take the following example:

> A business' last annual accounts span 1 November 2009 to 31 October 2010. The accounts were filed on 1 May 2011 and it buys insurance on 1 September 2011.

A.43 It is unclear whether the conversion to euros should depend on the rate applicable on 31 October 2010 (when the accounting year ends); on 1 May 2011 (when the accounts are filed); or on 1 September 2011 (when the insurance contract is formed). In a world of currency fluctuation the decision may make a difference. An unsophisticated business may apply the wrong rate and therefore miscalculate its status.

DELAYS BETWEEN CALCULATING FIGURES AND BUYING THE POLICY

A.44 Second, there can be a lengthy delay between the micro-business' turnover calculation and the insurance policy being bought.

A.45 A small company can set its own financial year for submitting its accounts to Companies House. It must submit them within nine months of the end of its financial year. If, for example, its financial year runs from 1 June 2010 to 31 May 2011, it does not have to submit accounts until 28 February 2012. That means that it could buy an insurance policy in early February 2013 using turnover or balance sheet figures mainly from 2010.

A.46 There is a similar time lag in the case of sole traders' and partnerships' annual accounts. Their financial year finishes in April of each year, and they are not required to submit their annual tax returns until 31 January of the following year. This time lag may lead to problems as micro-businesses can grow rapidly.

A.47 The European Commission has provided that a micro-enterprise may exceed the headcount or financial limits for two consecutive accounting periods before it loses its status as a micro-enterprise. Using the example above, the effect is that a company buying insurance in early 2013 could still qualify as a micro-enterprise on the basis of accounts covering the period 1 June 2008 to 31 May 2009. These figures may be an inaccurate representation of the scale of the business at the time of buying insurance.

NEW ENTERPRISES

A.48 Third, the rules on defining micro-enterprises are particularly problematic when applied to new enterprises. These businesses have to calculate their turnover/ balance sheet by making a "bona fide estimate of the relevant data during the course of the financial year".

A.49 Projected turnover figures are inherently inaccurate and unreliable and many small businesses will have little idea of their likely turnover. There may be an incentive to under-estimate turnover so as to fall within the consumer insurance regime.

The independence requirement

A.50 The definition adopted by FOS divides enterprises into three categories: autonomous, partner and linked enterprises. Each corresponds to a type of relationship which an enterprise might have with another. For autonomous enterprises one looks only at the headcount and turnover of the business in question. For partner enterprises, one includes a proportion of the headcount and turnover of the partner business. For linked enterprises, the figures are aggregated across the whole group.

A.51 Although it is right to exclude small subsidiaries of larger companies from micro-business status, the test is complex.

AUTONOMOUS ENTERPRISES

A.52 An enterprise is autonomous if it is totally independent of other businesses. A business can also be autonomous if:

(1) it has a holding of less than 25% of the capital or voting rights (whichever is the higher) in one or more other enterprises; and

(2) another party does not have a stake of 25% or more of the capital or voting rights (whichever is the higher) in the enterprise.

A.53 It is possible to have several investors each with a stake of less than 25% in the business, provided that these investors are not linked to each other.

A.54 There are several exceptions to these rules. An enterprise can still be ranked as autonomous if the 25% limit is reached or exceeded by certain types of investors, for example, public investment corporations, venture capital companies and business angels,[10] institutional investors, including regional development funds, or autonomous local authorities with an annual budget of less than 10 million euros and fewer than 5,000 inhabitants. Each of these may have a stake of no more than 50% of the enterprise, provided they are not linked to each other.

PARTNER ENTERPRISES

A.55 An enterprise is classified as a partner enterprise if it has a holding equal to or greater than 25% of the capital or voting rights in another enterprise and/or another enterprise has a holding equal to or greater than 25% in the partner enterprise. If an enterprise is a partner enterprise, it must add a proportion of the other enterprise's staff headcount and financial details to its own data. This proportion will reflect the percentage shares or voting rights, whichever is the higher, that are held.

LINKED ENTERPRISES

A.56 Linked enterprises are those which form a group through the direct or indirect control of the majority of voting rights of an enterprise by another or through the ability to exercise a dominant influence on an enterprise.

[10] Business angels are defined as individuals or groups of individuals with a regular venture capital investment activity who invest equity capital in unquoted businesses.

A.57 Two or more enterprises are linked when they have any of the following relationships:

(1) One enterprise holds a majority of the shareholders' or members' voting rights in another.

(2) One enterprise is entitled to appoint or remove a majority of the administrative, management or supervisory body of another.

(3) A contract between the enterprise, or a provision in the memorandum or articles of association of one of the enterprises, enables one to exercise dominant influence over the other.

(4) One enterprise is able, by agreement, to exercise sole control over a majority of the shareholders' or members' voting rights in another.

A.58 In the case of linked enterprises, all of the linked enterprise's data must be added to those of the enterprise to determine if the business complies with the headcount and financial limits.

A.59 The SME user guide says that a business generally knows immediately that it is linked, since in most member states, it is required by law to draw up consolidated accounts or is included by consolidation in accounts of the other enterprise. However, in the UK, from 6 April 2008 new regulations replaced the accounting and reporting schedules to the Companies Act 1985.[11] Under these regulations small groups of companies are no longer required to prepare consolidated accounts.[12]

A.60 Under the above rules, determining the status of a business will be no simple task, with the risk of creating uncertainty for both insurers and insureds.

Excluding sophisticated businesses

A.61 In Issues Paper 5, we discussed the problem of sophisticated businesses such as special purpose vehicles (SPVs). An SPV might be set up to carry out a highly sophisticated project, such as securitising mortgage assets, and yet have few (if any) employees and a low (if any) turnover. We were concerned that if an SPV were to be engaged in complex litigation over non-disclosure it could claim that it met the micro-business test.

[11] Small Companies and Groups (Accounts and Directors' Report) Regulations 2008; Companies Act 2006 (Amendment) (Accounts & Reports) Order 2008; Directive 2006/46/EC.

[12] Small groups of companies are defined as those that meet two of the following three criteria: 1) aggregate number of employees of no more than 50, 2) aggregate annual turnover of no more than £6.5 million net or £7.8 million gross, 3) aggregate balance sheet total of no more than £3.26 million net or £3.39 million gross.

A.62 The complexities of the European definition go some way to excluding linked companies, but they are not wholly effective. For example, under the EU definition, orphan companies could avoid being classified as partner or linked enterprises. The shares of orphan companies are often settled on charitable trusts and their directors are provided by administration companies, as it may be important for regulatory and tax purposes that there is no connection between the orphan and the larger sponsor company.

A.63 In Issues Paper 5, we suggested other possible approaches to excluding sophisticated businesses from the definition of micro-businesses. One option was to look at insurance premium spend. We suggested that those businesses that spent over £15,000 on an insurance policy would fall within the business regime, regardless of business' size. This would mean that parties to expensive insurance policies would have more freedom to agree terms.

A.64 Six consultees gave views on our proposed additional "sophistication filters". Five expressed concerns about how they would work in practice. On insurance premium spend the ABI told us about a disadvantage of the approach of a premium spend per policy:

> For some products the customer would be treated as 'micro' and others not. This could also result in penalising micro-businesses who have greater insurance risks as a result of the nature of their business or location.

A.65 Beachcroft commented:

> These are all seemingly arbitrary lines in the sand that will inevitably, over time require amendment.

A.66 Aviva concluded:

> We are of the view that there is no merit in introducing a complicated division of rules that would be difficult to operate in practice. Any mechanism designed to distinguish micro-businesses from small businesses would introduce a layer of complexity and regulation which would ultimately have a bearing on premium levels to the detriment of customers.

Asking questions about business size

The need for additional questions

A.67 If a definition based on employee numbers and turnover was adopted, insurers would need to ask questions about these issues. We were told that insurers already have their own ways of classifying small/SME business for their own purposes. However, the criteria they use differ between the insurers and sectors. For example, Royal and Sun Alliance informed us that for non-motor insurance their criteria are based around number of premises, sums insured and turnover. For motor insurance, they use vehicle weight and number of vehicles. Applying a single definition would involve significant changes. New questions, new forms and new systems would need to be developed.

A.68 In discussion the ABI expressed concern about how many questions they would need to ask, and how far they could rely on the answers given. The Institute of Insurance Brokers felt that insurers should not take responsibility for this issue:

> We strongly disagree with the prospect of insurers having to determine the status of the firm for underwriting purposes.

The consequences of mistakes

A.69 Small to medium sized businesses may well make an error when calculating their status and incorrectly conclude that they are micro-businesses. What would be the consequences of this mistake?

A.70 Under our original proposal, we suggested that if a business misrepresents itself to be a micro-business, that misrepresentation should not, of itself, immediately defeat the business' claim under the policy. However, the business would fall under the business insurance regime, which means that it would be subject to a pre-contractual duty of disclosure. Yet the business may be completely unaware that it should have volunteered information for which it was not asked. If the business failed to mention material information, the consequences may well be that its claim would be refused.

A.71 We were concerned that a business which applied the definition incorrectly may find itself in a worse position than under the current law. At present, businesses are warned about the duty of disclosure, whereas following the reform the business may genuinely think that the duty of disclosure does not apply to it.

Alternative approaches

A.72 Following responses to Issues Paper 5 and our concerns over the FOS definition, we considered alternative tests for micro-businesses. Informally, we discussed a definition which concentrated on sole traders and small partnerships consisting of two natural partners with unlimited liability. We also considered that there should be a maximum employee headcount for such businesses of no more than 5 employees.

A.73 Even this limited test could be difficult to apply in practice. Some family run firms may not be aware that the law would regard a son, daughter or spouse as a partner in the business. It also raises the question of whether a part-time employee should count as a proportion of an "annual work unit". If so, the business would need to add up the hours worked by each part-time or casual employee during the year. If not, a firm with a succession of part-time staff could be excluded from the definition.

A.74 Some consultees suggested that businesses should be treated as consumers if they bought directly from the insurer without using an intermediary. Yet the presence of an intermediary does not guarantee protection. Intermediaries come in different forms: while some offer full advice, others only execute the sale. The test might also act as an incentive not to use an intermediary. Furthermore, some very sophisticated parties may place insurance directly: for example, an insurer may place reinsurance without a broker, or a broker may take out professional indemnity on its own behalf. It would be inappropriate to provide consumer-type protection to sophisticated buyers simply because they failed to use an intermediary.

THE COSTS OF A "THIRD CATEGORY"

A.75 Many insurers currently organise their operations in terms of consumer insurance and business insurance. There was concern that the creation of a "third category" for micro-businesses would result in additional costs. The ABI commented:

> Creating a 'third category' of customers would impose additional costs on insurers. Although it is difficult to quantify these costs at this stage, they are likely to be substantial. The proposals would entail (amongst other things) implementation costs, process documentation and IT changes, additional compliance/regulatory issues, ongoing administrative costs, large scale staff training and the likelihood of an increased number of disputes. These additional costs have to be passed onto customers in the form of higher premium.

A.76 Insurers were concerned that the creation of a special "micro-business regime" for all the purposes of disclosure and unfair contract terms would have repercussions for all regulatory issues. Following further consultation, the ABI sent us a summary of insurers' comments which stated:

> There are issues around ICOBS customer classification and whether an insurer is a "customer" or a "consumer". Should an employee threshold be introduced, this would result in the anomaly under which a single product is both "consumer" and "customer" based with different questions, duty of disclosure, UCTA and alike, pertaining to the relevant classification.

A.77 Insurers also thought that they would need to develop special product ranges for micro-businesses. As the ABI summary put it:

> An insurer could end up with two versions of the same product, one for micro-businesses and one for all others. This would be very costly to develop, implement and maintain. Insurers will have to consider and manage the "hybrid potential" of the same product being used for an entire spectrum of commercial business from a sole trader to a major UK corporation.

A.78 Insurers were concerned that for micro-businesses they would need to ask more questions, both to find out if a business was a micro-business and to compensate for the lack of a duty to volunteer information. Existing documentation and underwriting systems would have to change. Insurers said that the precise costs of this were difficult to predict but were likely to be substantial.

A.79 It was also suggested that the reform may lead to some products being withdrawn from micro-businesses. It said that margins in this sector were thin; if an insurer could no longer rely on disclosure, it may be reluctant to underwrite, especially if the business's operations were novel or unusual.

A.80 We accept that the proposal to provide micro-businesses with special protection would create some additional costs, if only the cost of asking additional questions about business size. These costs might be justified, but only if there was compelling evidence that the current law causes serious problems in practice. As we explore below, we have not found such evidence.

IS THERE A PROBLEM IN PRACTICE?

A.81 The insurers we spoke to indicated that non-disclosure was not a major problem among their small business customers. For example, RSA told us that in the past year (2010 to 2011) only 15 of 100,000 small business non-motor policies were avoided. Similarly, consultations with small businesses did not reveal large numbers of problems.[13] None of the 25 small businesses who responded to our questionnaire, for example, reported that they had had a claim turned down for reasons of non-disclosure.[14]

A.82 To explore this further, we undertook two surveys on the issue of non-disclosure, one with the British Insurance Brokers' Association (BIBA)[15] and one through the ABI.[16] Again, these surveys did not suggest that there were large numbers of disputes over non-disclosure and misrepresentation in this sector.

The BIBA survey

A.83 We worked with BIBA to design a questionnaire which was sent to BIBA members from November to December 2010.[17] BIBA received 176 responses. All but 3% of brokers replying had dealt with claims from very small businesses within the last two years, with the number of claims dealt with ranging from less than 10 to more than 100.[18]

A.84 Out of the brokers replying, over half (55%) said that none of the claims they dealt with in the last two years had involved a dispute about non-disclosure or misrepresentation. Of those who had been involved in such a dispute, most had encountered between 1 and 5 such disputes. Only 8% of brokers in the survey had encountered more than 5 disputes over non-disclosure or misrepresentation in the last two years.

[13] In consultation with the Federation of Small Businesses, one regional response indicated that they had been dealing with some non-disclosure issues.

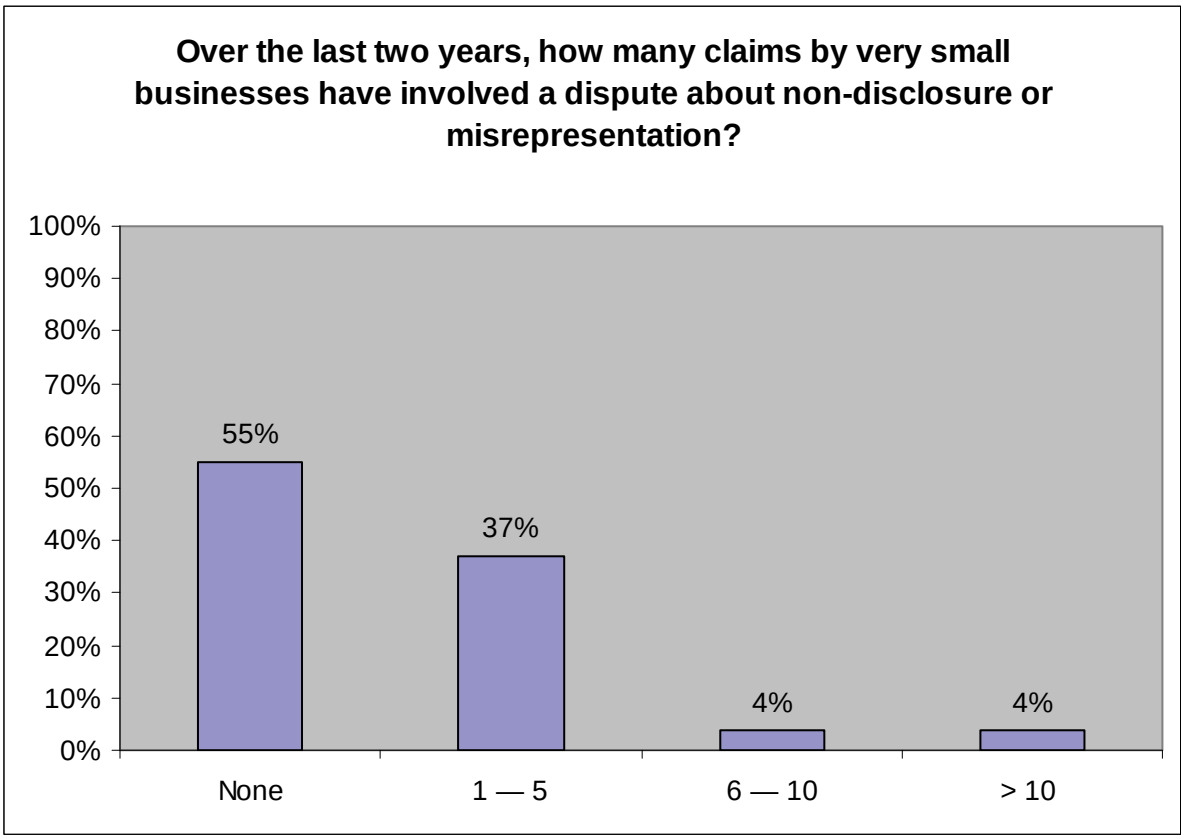
[14] The questionnaire on the Small Firms Consultation Database asked "have you ever had a claim turned down because you didn't provide enough information to insurers when you took out your policy?"

[15] Details of this survey were published in *The Broker*, February 2011.

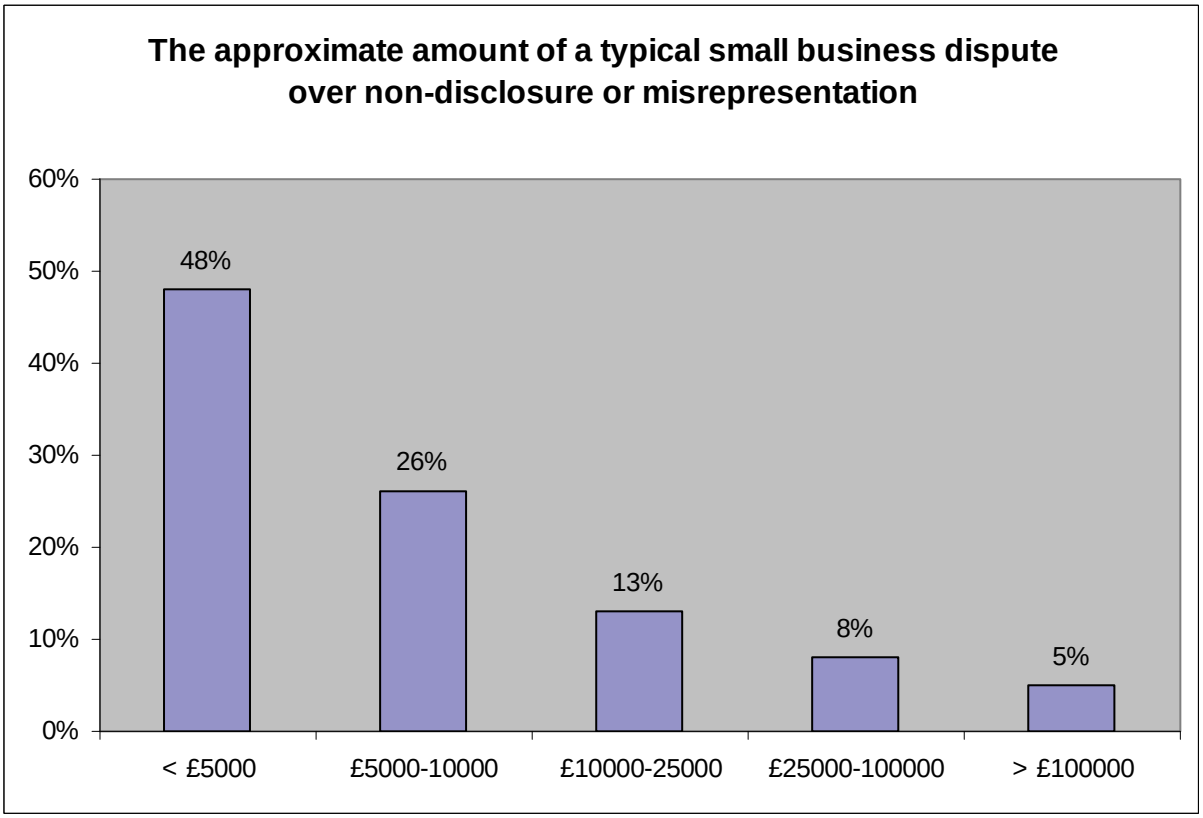
[16] ABI survey, January 2011.

[17] In 2010, 1,700 firms were members of BIBA. The survey was sent to 3,563 email addresses but in many cases the same firm had several addresses. Members were asked to send one reply for the whole firm.

[18] 53% of respondents had dealt with more than 25 claims from very small businesses in the last two years and 32% had dealt with more than 50 claims.



A.85 Where there were disputes about non-disclosure or misrepresentation, most involved relatively small amounts of money. Just under half (48%) involved less than £5,000. Only 5% involved over £100,000.



A.86 The most common category of insurance giving rise to disputes was building or contents insurance (40%), followed by public or product liability insurance (22%) and motor insurance (18%).

A.87 Brokers were asked whether they thought that the law of non-disclosure presents a problem for very small businesses. Almost a third (31%) said that it was not a problem; 58% said it was sometimes a problem; and only 11% said it was often a problem. One respondent said that it handled 6,000 micro-business policies but "the number of disputes was tiny, the number that cannot be resolved is scarcely measurable". Another broker commented:

> Whilst there are circumstances where non-disclosure will undoubtedly occur we have not experienced it being a systemic failing of the industry. Any claims turned down for what ever reason are measured as part of our FSA Treating Customers Fairly metrics.

A.88 Several brokers commented that the problems arose from businesses buying online or from the use of statements of fact. Where a broker advised the business on filling in a proposal form, problems were minimised.

A.89 These findings suggest that while there are disputes over non-disclosure and misrepresentation in the micro-business market, the problem is not a major one.

The ABI survey

A.90 We sent a similar questionnaire to the ABI asking if any of their members could participate.[19] Based on this questionnaire the ABI told us:

(1) From the number of total complaints received from small businesses, less than 0.001% of complaints were based on non-disclosure or misrepresentation.

(2) The most common insurance products that the disputes are about are buildings/contents cover (as the BIBA survey), and public/product liability.

(3) The average small business claim for non-disclosure or misrepresentation is £7,500 (similar to the BIBA survey which was £5,000).

THE ROLE OF THE FOS

A.91 Micro-businesses are entitled to complain to the FOS provided they meet the definition discussed in paragraphs A.33 to A.35 above. The definition is applied at the time the complaint is made, rather than when the insurance is placed. FOS does not apply the strict letter of the law, but decides disputes "by reference to what is [in the opinion of the ombudsman] fair and reasonable in all the circumstances of the case".[20]

[19] The ABI circulated the questionnaire in October 2010. They told us that they received replies from firms representing around a third of the general insurance market.

[20] Financial Services and Markets Act 2000, s 228(2).

A.92 FOS recommendations are binding on the insurer up to a set amount. In 2011 the limit was £100,000, but it was increased to £150,000 on 1 January 2012.

FOS decision-making

A.93 In deciding what criteria to apply to the dispute, FOS considers the nature of the business. Unsophisticated businesses are often treated in the same way as consumers while sophisticated businesses are not afforded the same protections. In making this distinction, FOS looks at all the circumstances, including whether the business was professionally advised.

A.94 An example of a dispute involving an "unsophisticated" business is given in Ombudsmen News. Mrs A ran a small graphic design business. Her premises were broken into and she lost computer equipment. She also suffered damage to her premises. Her claim was turned down by her insurer stating that her doors were "not of the correct construction". Mrs A's business turnover was modest and she only had two part time employees. The FOS took the view that the insurer should have treated her as if her claims had been made by a consumer and her claim was handled on this basis. FOS concluded that the thieves would have got in to the premises regardless of the precise construction of the door.[21]

A.95 The FOS stated in relation to Mrs A's case:

> We take the view that it is fair and reasonable to judge complaints from large businesses – and from those with a more sophisticated knowledge of insurance – by legal standards. However, if we think it should have been clear to the insurer or intermediary that the business was an *unsophisticated* buyer of insurance, we are likely to judge the complaint as if it had been made by a consumer.

A.96 By contrast, in our 2007 Consultation Paper we described a case where the policyholder was a firm of insurance brokers. The ombudsman decided that the inequality of bargaining power often present between small businesses and insurers did not apply. Instead the complainant's size, status and knowledge of insurance law meant that it would be appropriate to apply normal legal principles.[22]

A.97 Even for relatively sophisticated businesses, the FOS told us that most non-disclosure disputes concern an incorrect answer to a question rather than a failure to volunteer information. Furthermore in some "sophisticated" cases the FOS will apply proportionate remedies. The FOS observed that some insurers also appear to apply proportionate remedies to commercial claims.

[21] Ombudsman News issue 74, December 2008/2009

[22] Insurance Contract Law: Misrepresentation, Non-disclosure and Beach of Warranty by the Insured; (2007) LCCP 182/ SLCDP 134 at Appx C, para C.101.

Numbers of cases

A.98 In March 2011, FOS helpfully provided us with an analysis of all micro-business disputes closed between April 2009 and February 2011. During this period, the FOS identified 1,985 insurance complaints from micro-businesses.[23] Of these, 92 were non-disclosure cases.[24] Most non-disclosure cases were resolved informally by adjudicators. In all, 76 (82%) were resolved by adjudicators; 11 (12%) went to a final ombudsman decision and 5 were withdrawn or abandoned.

A.99 Out of these 92 cases, 66 resulted in no change to the insurer's decision (the complaint against the insurer was not upheld). In 21 cases, the complaint was upheld, and the micro-business won. Of the remaining five, three were withdrawn and two were out of the FOS jurisdiction. In other words, the insurer's decision was confirmed in 72% of cases.

A.100 The rate at which the insurer's decisions were upheld appeared to be consistent with results we obtained in previous surveys of final ombudsman decisions:[25]

Cases: non-disclosure and misrepresentation	**2007**	**2009**	**2011**
Final ombudsman decisions surveyed	12	12	11
Insurer's decision upheld	9 (75%)	9 (75%)	9 (81%)
Insurer's decision overturned	3 (25%)	3 (25%)	2 (18%)

A comparison with consumer cases

A.101 The number of micro-business disputes about non-disclosure and misrepresentation reaching the FOS seems low, compared with the equivalent figure for consumers. In 2008 to 2009, the FOS considered around 83 cases a month about consumer non-disclosure and misrepresentation.[26] From April 2009 to February 2011 the equivalent monthly figure for micro-businesses was 4.

[23] This number represents complaints recorded in the following categories: commercial property insurance; commercial vehicle insurance; business protection insurance; and commercial legal expenses insurance.

[24] Some cases which include an element of non-disclosure may have been recorded as another complaint type which means that this figure may slightly under-represent the number of commercial non-disclosure cases considered.

[25] Insurance Contract Law: Misrepresentation, Non-disclosure and Beach of Warranty by the Insured; (2007) LCCP 182/SLCDP 134 at Appx C.

[26] Law Commission and Scottish Law Commission, Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation: Summary (December 2009) at para 1.20. The estimate was based on a survey of cases we conducted at the FOS offices in November 2009.

A.102 It is difficult to know the reasons for this. One reason, of course, is that there are fewer micro-businesses: while there are 23.6 million households in the UK,[27] there are only 4.6 million micro-businesses.[28] Micro-businesses may be less likely to make claims; they may be less likely to have issues of non-disclosure or misrepresentation raised against them; they may resolve problems more easily (through brokers for example); or they may be less aware of their right to complain to the FOS.

A.103 Micro-businesses also appear to have a lower success rate before the FOS than consumers. Our survey of final ombudsman decisions between January 2008 to July 2009 about consumer non-disclosure and misrepresentation showed that half of consumers were successful.[29] There are many possible reasons for this.

A.104 Although it is difficult to interpret the FOS figures, they do not suggest a widespread problem with the law of non-disclosure in this sector.

THE STATUS OF INTERMEDIARIES

A.105 In this final section we explain why we are no longer proceeding with proposals to enact new rules to determine the status of intermediaries in the commercial insurance market. As discussed below, in the consumer market, rules on this issue were enacted in the Consumer Insurance (Disclosure and Representations) Act 2012. We do not think that similar rules are needed in the commercial market. Most small businesses continue to use independent brokers, who clearly act for the policyholder, and reform would risk introducing uncertainty.

The status of intermediaries in consumer insurance

A.106 In our 2009 Report on Consumer Insurance[30] we said that in the consumer market many problems over non-disclosure involved allegations about what an intermediary said or did in the placing of insurance. Where an intermediary was at fault in transmitting pre-contact information from the policyholder to the insurer, the outcome would depend on whom the intermediary acted for. If the intermediary acted for the insurer, the insurer would be obliged to pay the claim, and then bring an action against the intermediary. If the intermediary acted for the consumer, the insurer could refuse the claim and the consumer would need to pursue the intermediary for compensation.

A.107 We said that it was often difficult to determine for whom the intermediary acts, given the wide variety of intermediaries in the consumer insurance market:

[27] Office for National Statistics, Statistical Bulletin: Families and Households 2001 to 2011 (January 2012).

[28] BIS Small Business Survey 2010 (April 2011), para 3.2.

[29] Consumer Insurance Law: Pre-contract Disclosure and Misrepresentation; (2009) Law Com No 319; Scot Law Com No 219, Appx C at para C.21.

[30] (2009) Law Com No 319; Scot Law Com No 219.

> At one extreme they may be very closely linked to the insurer – for example, the intermediary may be recruited by the insurance company to solicit customers. At the other extreme, the intermediary may be an independent agent, chosen and approached by the consumer and able to offer impartial advice on the market. In the middle lies a broad spectrum of diverse arrangements. Since the depolarisation of the insurance market in 2005, intermediaries are no longer required to be either independent or tied to a single insurer. They may be "multi-tied" – which could mean virtually independent or closely linked to only two insurers.
>
> New methods of selling insurance are constantly being introduced. For example, the intermediary may be a retailer which offers a limited range of insurance products (such as extended warranties) as a sideline; or the intermediary may be a large recognised brand (such as a supermarket or a bank) which distributes insurance products under its own logo (known as "white-labelling"). Information technology has prompted considerable change as internet selling and price comparison sites have become increasingly important.[31]

A.108 The Consumer Insurance (Disclosure and Representations) Act 2012 therefore includes new rules to determine the status of an intermediary, set out in Schedule 2. These rules only apply to consumer insurance contracts, and only for the purposes of that Act.[32]

A.109 In three circumstances, an intermediary is always considered to act for the insurer. These are where:

(1) the intermediary is the appointed representative of the insurer;

(2) the intermediary has actual express authority from the insurer to collect pre-contract information on its behalf (for example, through an express term in a terms of business agreement);

(3) the intermediary has authority to bind the insurer to cover.

A.110 In other cases, the intermediary acts for the consumer unless in light of all the relevant circumstances, it appears that the agent acts for the insurer. The schedule sets out a list of factors which are relevant to the decision.

[31] Above, at paras 8.9 to 8.10.

[32] See Sch 2, para 1.

Are similar rules needed for micro-businesses?

A.111 In Issues Paper 3 we noted that in the business market it was relatively rare for insurance to be sold through tied or multi-tied agents. The great majority of business was placed through independent brokers: for these types of insurance we proposed no change.[33] We noted, however, that some small businesses may use tied or multi-tied agents. We tentatively proposed to apply the consumer rules to small businesses in these circumstances.[34]

A.112 In our 2007 Consultation Paper we repeated our view that the problem only affected small businesses, but thought that it would be difficult to define a small business. We provisionally proposed that in the business market an intermediary should be regarded as acting for the insurer if it dealt with only a limited number of insurers and did not search the market on the insured's behalf.[35]

A.113 A large majority of consultees argued against this proposal. Out of 61 consultees who responded, 43 did not agree. Consultees were particularly concerned that a test aimed at small businesses would also apply to larger businesses. Many pointed out that in a specialist market a broker may act on behalf of a policyholder while only dealing with a limited number of insurers and not conducting a formal search of the market.

A.114 Many consultees thought that there was no need to reform the law on this issue. As Munich Re Life Branch said:

> We are very sceptical as to whether the complexity of intermediary relationships in the business (and the reinsurance) context can be summed up in a single test. While greater clarity is welcome, flexibility it also important and we are not convinced that this complex area should be dealt with through law reform.

A.115 The Commercial Court Users Committee commented:

> In commercial insurance, it is rarely in doubt that the broker will assume a responsibility to the insurer, but this seldom arises and will depend on the particular facts of the case. Again we consider that concerns about the role of brokers in the consumer context are influencing proposals for reform in the business context, where reform is really not needed.

[33] Insurance contract law: Issues Paper 3, Intermediaries and pre-contract information, (March 2007) para 7.3.

[34] Above, para 7.6.

[35] (2007) LCCP 182/ SLCDP 134, para 10.59.

Small businesses' use of brokers

A.116 In Issues Paper 5 we quoted research carried out by CRA International which suggested that micro-businesses were becoming less likely to use independent brokers. Instead, they were increasingly buying insurance in the same way as consumers.[36] The report found that only around half of companies with a turnover of less than £500,000 bought insurance directly from insurers.

A.117 This proved controversial. In June 2009 the Institute of Insurance Brokers wrote to us to say:

> We are concerned that the [CRA] market research data used may not accurately reflect the current situation. For example, it suggests that 50% of the smallest companies bought their insurance direct from insurers. From the experience of our members, who comprise independent brokers across the UK, this figure seems a gross overstatement.

A.118 The ABI tracks the distribution channels used by commercial insurance each year. The ABI figures show that between 2001 and 2009 the use of independent brokers remained fairly steady, at around 80% of the market. Businesses are far less likely than consumers to use tied agents or other forms of intermediary. In 2010, 80% of insurance was sold through independent intermediaries, 9% from insurers, 8% through "company agents" and only 3% through other channels.[37] In 2009 a survey by BIBA looked specifically at firms with fewer than 10 employees. Two-thirds had bought insurance from brokers who were able to provide independent advice.[38]

A.119 Our discussions suggest that online sales have increased for motor insurance. In other areas, however, small businesses' use of brokers appears to be holding steady. In our 2010 survey, over half of BIBA members said that broker sales to small businesses were staying the same, 37% said they were increasing and only 11% said they were decreasing.[39]

The status of intermediaries: conclusion

A.120 We have concluded that it is not necessary to provide new rules to determine the status of intermediaries in the business insurance market. Most business policyholders continue to use independent brokers, and here the law is clear: the broker acts for the policyholder. Any reform in this area would provoke concern and may introduce uncertainties.

[36] "Commercial insurance commission disclosure: Market failure analysis and high level cost benefit analysis," CRA International by commission by the FSA (December 2007).

[37] ABI Data Bulletin, Sources of Premium Income for General Insurance 2010 (August 2011).

[38] BIBA, Report on the Importance of Advice in the Small to Medium Enterprise Market (April 2009).

[39] BIBA survey, November-December 2010.

A.121 For consumer insurance, new rules were introduced to clarify the status of a wide variety of intermediaries, including those selling "white labelled" products,[40] aggregators and panel agents. In the business market these arrangements are rare.

A.122 We are aware that some small businesses buy motor insurance through "consumer type" sales channels, such as aggregators. We have considered what would happen if an aggregator were to introduce errors into the disclosure process by, for example, inappropriately pre-populating submissions.

A.123 In the consumer market, if the dispute came before a court, the court would need to consider whether the aggregator acted for the consumer or the insurer, applying the rules in Schedule 2 of the Consumer Insurance (Disclosure and Representations) Act 2012. We think that in practice the courts would apply similar rules to any commercial insurance sold by the aggregator. This is because by and large schedule 2 codifies the current law. The same factors would be relevant. We do not think that it is necessary to introduce new legislation to produce this outcome.

CONCLUSION

A.124 It has proved extremely difficult to define micro-businesses. The definitions we considered were either insufficient to exclude sophisticated businesses, or overly complex, or both. Some SMEs would incorrectly conclude that they fall into the category of micro-businesses, with the result that the pre-contractual duty of disclosure would apply to them without their knowledge. This could make their position more difficult than it is at present.

A.125 A new definition will also require insurers to change their systems to include a "third category" of customers, which would involve additional costs. This would only be justified if there was compelling evidence of problems. Despite surveys and consultation, we have not found evidence that micro-businesses have particular problems with the current law of non-disclosure and misrepresentation. Where a dispute does arise, micro-businesses have access to the FOS as a low-cost dispute resolution option.

A.126 For these reasons we do not propose to enact special protections for micro-businesses.

[40] "White labelling" is where the insurance in question is marketed under the name of the agent.