



**Law
Commission**
Reforming the law


Scottish Law Commission
promoting law reform

Reforming Insurance Contract Law

Issues Paper 5: Micro-Businesses

Should micro-businesses be treated like consumers for the purposes of pre-contractual information and unfair terms?

April 2009

CONTENTS

	<i>Paragraph</i>	<i>Page</i>
<i>Summary</i>		iv-viii
PART I: INTRODUCTION		1
Background	1.6	1
Previous proposals	1.8	2
New proposals	1.11	2
Status of this paper	1.14	3
Responses to this paper	1.15	3
Thanks	1.18	3
<i>SECTION A: BACKGROUND</i>		
PART 2: THE CHARACTERISTICS OF MICRO-BUSINESSES		4
Introduction	2.1	4
General characteristics of small and micro-businesses	2.3	4
PART 3: PROPOSALS IN THE CONSULTATION PAPER		10
Consultation paper	3.1	10
Responses	3.3	10
Conclusion	3.7	11

SECTION B: MICRO-BUSINESSES AND PRE-CONTRACTUAL INFORMATION

PART 4: PLACING MICRO-BUSINESSES IN THE CONSUMER REGIME		12
Our proposal	4.1	12
The effect of treating micro-businesses as consumers	4.5	12
Small businesses	4.9	13

SECTION C: UNFAIR TERMS AND WARRANTIES OF FUTURE CONDUCT

PART 5: UNFAIR TERMS		15
Introduction	5.1	15
The UTCCR: an outline	5.6	16
What terms in an insurance contract would be covered?	5.31	20
Should micro-businesses be given UTCCR type protection? The policy arguments	5.34	21
PART 6: THE PROBLEM OF WARRANTIES OF FUTURE CONDUCT		23
Introduction	6.1	23
Warranties of future conduct in micro-business contracts	6.2	23
How would a warranty of future conduct be dealt with under the Unfair Terms in Consumer Contracts Regulations 1999?	6.5	24
Reform of sections 33 and 34 of the Marine Insurance Act 1906	6.14	26

SECTION D: DEFINITION OF MICRO-BUSINESS

PART 7: BASIC DEFINITION OF MICRO-BUSINESS		30
Introduction	7.1	30
The proposed tests for defining a micro-business	7.5	30
Option 1 – turnover definition	7.9	31
Option 2 – employee definition	7.20	33

Option 3 – Financial Ombudsman Service jurisdiction limit	7.37	36
Excluded option: The BERR and European Commission definition	7.43	37
PART 8: THE PROBLEM OF SOPHISTICATED MICRO-BUSINESS		38
Introduction	8.1	38
Associated businesses	8.2	38
Insurance premium spend	8.7	39
High asset and turnover filters	8.9	40
Sophistication filters - conclusion	8.14	40
PART 9: THE TEST IN PRACTICE		42
Introduction	9.1	42
Process	9.4	42
Misrepresentations about size	9.8	43
PART 10: PROPOSALS AND QUESTIONS		45
APPENDIX A: DEFINITIONS OF ASSOCIATED BUSINESSES		49

SUMMARY OF PAPER: REFORMING INSURANCE CONTRACT LAW: MICRO- BUSINESSES

- 1.1 This document summarises the contents of the Law Commissions' joint Issues Paper entitled "Reforming Insurance Contract Law: Micro-businesses". That Paper consults on a new approach to the smallest businesses and insurance contract law. We ask whether the very smallest businesses (micro-businesses) should be treated like consumers for the purposes of pre-contractual information and for potentially unfair terms in their contracts of insurance. We ask for responses by 17 July 2009.¹

INTRODUCTION²

- 1.2 Insurance contract law can be harsh on policyholders. The law as set out in the Marine Insurance Act 1906 states that when taking out a contract of insurance, policyholders have to supply an insurer with all information that would influence a prudent underwriter in deciding whether to write the risk or at what price it should be written. This is the case even if the policyholder has not been asked for the information. For consumers this has now been overlaid by rules contained in the Financial Services Handbook and industry codes of practice. The Financial Ombudsman Service also has the right to decide cases according to what is fair and reasonable in the circumstances.
- 1.3 In July 2007 we published a Consultation Paper which set out possible reforms for both business and consumer policyholders in the areas of pre-contractual information and potentially unfair terms. The proposals aimed to bring the law into line with good industry practice and the practice of the Financial Ombudsman Service. The reforms proposed for businesses differed from those proposed for consumers.

¹ Our proposals for reform and questions are listed within the text of the main Paper and are set out in full in Part 10. We would be grateful if responses could be sent:

by email to: commercialandcommon@lawcommission.gsi.gov.uk ; or

by post to: Elizabeth Waller, Law Commission, Steel House, 11 Tothill Street,
London SW1H 9LJ (tel: 020 3334 0282);

by fax to: 020 3334 0201, marked for the attention of Elizabeth Waller.

It would be helpful if, where possible, comments sent by post could also be sent on disk, or by email to the above address, in any commonly used format. As the Law Commission will be the recipient of responses, the Freedom of Information Act 2000 will apply and all responses will be treated as public documents. We may attribute comments and include a list of all respondents' names in any further report we publish. Those who wish to submit a confidential response should contact the Law Commission before sending the response. Automatic confidentiality disclaimers generated by an IT system will be disregarded.

² For more detail please see Parts 3 and 4 of the Issues Paper.

Consumer reforms

- 1.4 We proposed that consumer policyholders will no longer have to volunteer information to an insurer. Instead, an insurer will have to ask questions about all matters which are relevant to it. Consumers will have to answer carefully all the questions asked of them by insurers.
- 1.5 Where a consumer gives inaccurate information then the consequences will depend on what sort of misrepresentation the consumer made.
 - (1) Where the consumer acted deliberately or recklessly, the insurer would be entitled to avoid the policy and refuse to pay all claims.
 - (2) Where the consumer acted negligently in making the misrepresentation, the insurer would have a proportionate remedy. This looks at what the insurer would have done had it known the true facts. For example, if the insurer would have imposed an exclusion, the policy would be treated as including that exclusion. If the insurer would have charged more, the consumer would only receive a proportion of his or her claim.
 - (3) Where a consumer acted reasonably, the insurer would be required to pay the claim in full.
- 1.6 When dealing with consumers, we proposed that insurers should not be allowed to contract out of these proposals so as to give themselves greater rights to reject claims because of inaccurate information.
- 1.7 Consumers also have the benefit of the Unfair Terms in Consumer Contracts Regulations 1999 which allow them to challenge unfair terms in insurance contracts. This might include unduly onerous notification clauses or exclusions which appear narrow but are defined much more broadly in the small print.

Business reforms

- 1.8 The proposals we made for business policyholders are different. Business policyholders would still have a duty to volunteer information, in some circumstances without being asked about it. Furthermore, insurers and policyholders would have the right to contract out of any statutory reforms. A business policy could therefore include terms which give insurers greater rights to reject claims for misrepresentations.
- 1.9 In the Consultation Paper, we argued that less sophisticated businesses needed more protection than this. The main problem with businesses is that the law has to cover a wide spectrum from multinational corporate giants to tiny corner shops. It is difficult to find one regime which is suitable for all. We therefore proposed a graduated test which looked at the way a business bought its insurance. If it bought a standard form insurance contract, we proposed that there should be controls on an insurer's ability to contract out of the reforms.
- 1.10 However, this graduated test caused uncertainty amongst both insurers and business policyholders. If an insurer did not know how many times it would have to contract on a particular set of terms for it to become a standard set, then a business policyholder would be even less likely to know whether it was contracting on standard terms.

NEW APPROACH³

- 1.11 We have therefore looked again at the problem of micro-businesses.
- 1.12 There are 4.5 million private business enterprises in the UK which have between 0 and 9 employees. These small enterprises provide employment for a third of employees working in the private sector. The majority of businesses of this size are structured as sole proprietorships (66%), rather than as companies or partnerships, and have an average turnover of less than £500,000. Research carried out by CRA International for the Financial Services Authority found that a business with a turnover of less than £500,000 a year spent between on average between 1.2 and 1.3% of its annual turnover on insurance.
- 1.13 As these companies have few (if any) employees, they are unlikely to have specialist insurance expertise in-house. CRA found that:
- The purchase of insurance is not undertaken by risk specialists but it is rather a component of another role (most likely the owner-manager). The result is that these clients are also the least financially sophisticated.
- 1.14 These businesses are also the least likely to use brokers. The CRA report found that around 50% of the smallest companies bought insurance directly from insurers, often using the internet to do so. Insurers are keen to increase this proportion. As a result, CRA found that some brokers are starting to withdraw from the micro-business sector, as insurers improve the direct sales channels.
- 1.15 The evidence above ties in with what we had been told by consultees in their responses to our Consultation Paper, which is that many of these smallest businesses are no more sophisticated than consumers when buying insurance. The Royal Institution of Chartered Surveyors said
- Our membership will have both very sophisticated buyers and far less sophisticated buyers; all will be businesses. However, the latter, who more often than not will be sole practitioners, may be little more sophisticated than 'consumers'.
- 1.16 If these businesses are no more sophisticated than consumers then it seems fair that they should be treated as consumers when they buy insurance. We have been told that insurers often underwrite such businesses in their personal line accounts. Small businesses with a turnover of less than £1 million already have the opportunity to take a claim to the Financial Ombudsman Service if they feel that an insurer has unfairly turned down a claim for misrepresentation or non-disclosure or if other terms of the contract are unfair. The Ombudsman will judge their cases on what is fair and reasonable. It would therefore be sensible if the law and practice were brought into line on the issue of micro-businesses.

³ For more detail, please see Part 2 of the Issues Paper.

- 1.17 As well as being fairer to micro-businesses to treat them as consumers, the scheme also has the advantage of removing the smallest businesses from the regime of law to be applied to larger businesses. Including micro-businesses within the consumer regime will enable us to consider a more balanced approach for business insurance law.

PROPOSALS AND QUESTIONS⁴

- 1.18 We therefore ask in this paper whether the consumer reforms described above should also apply to the smallest businesses.
- 1.19 We propose that the provisions detailed above on pre-contractual information (which are set out more fully in our consumer summary paper⁵) should be applied to micro-businesses and consumers alike.
- 1.20 In this Paper, we also ask questions about the application of the Unfair Terms in Consumer Contracts Regulations 1999. These Regulations form part of consumers' protection against unfair terms in their contracts, including insurance contracts. The Regulations, however, do not apply to businesses although the Financial Ombudsman Service may apply their principles to small business cases if it believes that it is fair and reasonable to do so. In order to avoid creating a difference between consumers and micro-businesses, we therefore ask whether it would be sensible to apply the Regulations to insurance contracts bought by micro-businesses.

DEFINITION⁶

Basic definition

- 1.21 If the scheme is to work, we need to define a micro-business. We propose that there should be a simple test for establishing whether a business is micro and we ask whether this simple test should be one of the following definitions:
- (1) Fewer than 10 employees; or
 - (2) A turnover of less than a specified amount, possibly £1 million; or
 - (3) Tied to the Financial Ombudsman Service jurisdiction, so that if a business is entitled to take a claim to the Ombudsman it will be defined as a micro-business. The Financial Ombudsman Service jurisdiction is currently set at a turnover of less than £1 million but there are plans to alter this to fewer than 10 employees AND a turnover of less than 2 million euros.

⁴ For more detail, please see Parts 4, 5 and 6 of the Issues Paper. All our proposals are also set out in full at Part 10.

⁵ Reforming Insurance Contract law, A Summary of Responses to Consultation (May 2008), http://www.lawcom.gov.uk/docs/ICL_summary_of_responses.pdf .

⁶ For more detail, please see Parts 7 and 8 of the Issues Paper.

Excluding sophisticated micro-businesses

- 1.22 In addition to the basic tests, there will need to be sophistication filters to prevent sophisticated businesses from being defined as micro-businesses. These will ensure that businesses such as special purpose vehicles, which may have very few employees or may hold assets but have no turnover, will not fall into the micro-business category.
- 1.23 First, we propose that the turnover or number of employees in any associated or group company should be added to the total when calculating the figure for the basic test above. We also propose two further filters so that businesses that spend more than a certain amount on a premium (possibly £15,000); or that hold assets or have a turnover of more than £10 million cannot be defined as micro-businesses. The idea is that these are secondary tests: it will be very clear for most businesses and insurers which businesses are meant to fall within the regime and which are not.
- 1.24 We are keen to hear from consultees on the most practical way to define micro-businesses.

CONCLUSION

- 1.25 The research we have carried out and the feedback we have received from consultees indicates to us that micro-businesses buy their insurance in very similar ways to consumers. We therefore propose that they should be treated as consumers for the purposes of pre-contractual information and that the reforms proposed for consumers on these topics should apply to micro-businesses. We also ask consultees for their views on the extension of the Unfair Terms in Consumer Contracts Regulations to micro-businesses' insurance contracts.
- 1.26 We look forward to receiving your views.

PART 1

INTRODUCTION

- 1.1 This paper discusses micro-businesses and insurance contracts. It asks whether the law should treat micro-businesses like consumers for the purposes of:
 - (1) pre-contractual information when they buy their insurance; and
 - (2) protection against unfair terms in their insurance contracts.
- 1.2 The Paper is divided into four parts. In Section A we describe micro-businesses (Part 2) and give some background on our previous proposals (Part 3). In Section B, we describe our proposals to treat micro-businesses like consumers for the purposes of pre-contractual information.
- 1.3 In Section C, we move on to the separate topic of potentially unfair terms in insurance contracts. Instead of making proposals, we make some suggestions and ask questions of consultees about the best ways to deal with these.
- 1.4 In Section D, we set out some potential definitions of micro-businesses. We are keen to find the most practical way for all parties to identify micro-businesses.
- 1.5 We would be grateful for views on our proposals and questions. A full list of all the proposals and questions are in Part 10 at the end of the Paper.

BACKGROUND

- 1.6 The Law Commission and the Scottish Law Commission are conducting a joint review of insurance contract law. In July 2007, the Commissions published a Consultation Paper which set out proposals for the reform of both consumer and business insurance law.¹ Over the next six months we received 105 responses and held over 50 meetings with interested parties.
- 1.7 During 2008 we published summaries of the responses we received to our Consultation Paper. The summary of responses on consumer insurance law was published in May 2008.² In October 2008 we published a summary of responses on business insurance. There was support for reform of business insurance from consultees but little consensus as to the form it should take.³

¹ Insurance Contract Law: Misrepresentation, Non-disclosure and Breach of Warranty by the Insured (2007) Law Commission Consultation Paper 182; Scottish Law Commission Discussion Paper 134. <http://www.lawcom.gov.uk/docs/cp182.pdf> .

² Reforming Insurance Contract law, A Summary of Responses to Consultation (May 2008), http://www.lawcom.gov.uk/docs/ICL_summary_of_responses.pdf. We are currently working on a draft bill and final report on consumer insurance which we hope to publish later this year.

³ For more detail see Part 1 of Reforming Insurance Contract law, A Summary of Responses to Consultation (October 2008), Business Issues http://www.lawcom.gov.uk/docs/ICL_summary_of_responses_business-issues.pdf

PREVIOUS PROPOSALS

- 1.8 In the Consultation Paper we put forward proposals on misrepresentation, non-disclosure and breach of warranty for consumers on the one hand and businesses on the other. The regime of law that would apply to policies concluded between businesses and insurers was designed to be a default system so that the parties could contract out of it. However, the Paper argued that less sophisticated businesses would need more protection.
- 1.9 The Law Commissions therefore proposed a scheme that would protect the less sophisticated business policyholder that did not negotiate its contracts of insurance. If the contract was on the insurer's standard set of terms and if the particular terms had not been properly brought to the policyholder's attention (and therefore did not meet its reasonable expectations) then the insurer could not rely on the term if it gave the insurer more rights than it would have had under the default regime. The test was designed to prevent insurers contracting out of the reforms in the small print without bringing that to the policyholder's attention.
- 1.10 In our consultation meetings and also in the consultation responses it became apparent that there were difficulties with these tests.⁴ Consultees appeared to agree with the principle that less sophisticated businesses needed some extra protection but asked us to look again at the method of achieving it.

NEW PROPOSALS

- 1.11 This Paper therefore looks again at how best to protect unsophisticated businesses. The evidence in Part 2 shows that micro-businesses are very similar to consumers in the way that they buy insurance and in the knowledge they have of insurance law. Insurers are increasingly selling directly to these policyholders without the involvement of a broker. The Financial Ombudsman Service currently has jurisdiction to hear complaints where the policyholder is a business with a turnover of up to £1 million per annum.
- 1.12 We therefore propose that micro-businesses should be treated like consumers for the purposes of pre-contractual information and ask for consultees' views on the approach that should be taken to potentially unfair terms in contracts with micro-businesses. We propose a bright-line test to determine which businesses are unsophisticated micro-businesses, which consultees indicated they wanted, for the limited purposes of this Bill alone.

What we are not doing

- 1.13 Preliminary discussions with insurers have indicated concern that we are changing the definition of retail and consumer customers for regulatory purposes or for the purposes of other legislation. We are not. The definition of micro-business that we shall propose would be used purely for the purposes of pre-contractual information and unfair terms in insurance contracts and the ambit of the definition would be limited to the new Bill on these matters. It will not affect the Financial Services Authority's definition for the purposes of the ICOBS Rules or for any other legislation, for example the Distance Marketing Directive. We return to this later in Part 7.

⁴ See paras 3.3 and 3.4 below for further details.

STATUS OF THIS PAPER

- 1.14 This paper is an Issues Paper and therefore does not contain the final views of either Commission on the subject of micro-businesses. A further paper, containing the Commissions' conclusions, will be published at a later date.

RESPONSES TO THIS PAPER

Details for responses

- 1.15 Our proposals for reform and questions are listed within the text of this Paper and are set out in full in Part 10. We seek views on these proposals and questions by 17 July 2009 and would be grateful if responses could be sent:
- (1) by email to: commercialandcommon@lawcommission.gsi.gov.uk; or
 - (2) by post to: Elizabeth Waller, Law Commission, Steel House, 11 Tothill Street, London SW1H 9LJ (tel: 020 3334 0282);
 - (3) by fax to: 020 3334 0201, marked for the attention of Elizabeth Waller.
- 1.16 It would be helpful if, where possible, comments sent by post could also be sent on disk, or by email to the above address, in any commonly used format.

Freedom of information

- 1.17 As the Law Commission will be the recipient of responses, the Freedom of Information Act 2000 will apply and all responses will be treated as public documents. We may attribute comments and include a list of all respondents' names in any further report we publish. Those who wish to submit a confidential response should contact the Law Commission before sending the response. Automatic confidentiality disclaimers generated by an IT system will be disregarded.

THANKS

- 1.18 We would like to thank the following people who have assisted us in our work on this part of the project: ABI, AIRMIC, Professor Howard Bennett, Julian Burling, Richard Buttle, Christopher Butcher QC, Professor Malcolm Clarke, Derrick Cole, Colin Edelman QC, the Financial Ombudsman Service, Geoffrey Lloyd, Professor Robert Merkin, Baljeet Panesar, Dr Barış Soyer, Dr Caroline Sijbrandij, Christina Sparks, Alan Weir.

PART 2

THE CHARACTERISTICS OF MICRO-BUSINESSES

INTRODUCTION

- 2.1 In this Part, we describe small and micro-businesses in the UK. These businesses form a major part of the UK economy.
- 2.2 Later in this paper we suggest some definitions of a micro-business for the purposes of insurance contract law.¹ However in this Part we use definitions adopted by specific surveys which describe characteristics of micro-businesses and small businesses.

GENERAL CHARACTERISTICS OF SMALL AND MICRO-BUSINESSES

- 2.3 Each year, the Department for Business, Enterprise and Regulatory Reform (BERR) publishes figures on the characteristics of small and medium sized enterprises. The statistics distinguish between businesses on the basis of the number of their employees. The Enterprise Directorate who are responsible for the figures refer to businesses with 0-9 employees as “micro-businesses”, those with 10-49 employees as “small businesses”, those with 50-249 as “medium businesses”, and those with 250+ employees as “large businesses”.²
- 2.4 According to the statistics published in July 2008,³ there were 4.7 million private business enterprises in the UK at the start of 2007. Of these, 4.5 million (96%) had between 0 and 9 employees and 0.2 million (4%) had between 10 and 49 employees.⁴
- 2.5 Micro-businesses are an important part of the UK economy. The estimated private sector annual business turnover for the UK at the start of 2007 was £2,800 billion. It is estimated that businesses with between 0 and 9 employees account for 23% of that total turnover. Businesses with between 10 and 49 employees account for a further 15%.⁵

¹ See Section D.

² See <http://www.berr.gov.uk/whatwedo/enterprise/enterprisesmes/research-and-statistics/statistics/page38573.html>. See also the methodology note to the statistics for details on how they define an employee <http://stats.berr.gov.uk/ed/sme/smestats2007-meth.pdf>. Employees include those who are self employed and who run enterprises (paragraph 54) and would therefore include partners. Our own definition of employee is discussed later in the Paper, at para 7.20.

³ BERR, Statistical Press Release URN 08/92, 30 July 2008.

⁴ Just 33,000 (0.007%) businesses had more than 49 employees.

⁵ BERR, Table 1, UK Private Sector, number of employees divided by number of enterprises, <http://stats.berr.gov.uk/ed/sme/>.

- 2.6 BERR also reports that at the start of 2007, there were 22.7 million people employed by the private sector in the UK. Of these, 33% worked in businesses with between 0 and 9 employees. A further 14% worked in businesses with between 10 and 49 employees.⁶
- 2.7 Small and micro-businesses are spread over the whole of the UK's business activity. However, they are particularly dominant in some areas. In agriculture, fishing and forestry 94% of employment is in businesses with fewer than 50 employees. There are also high proportions of employment in such businesses in the construction sector (75% of employment in this sector is in businesses with fewer than 50 employees), private sector health and social work (72%), real estate/property, renting and business activities (56%) and hotels and restaurants (45%).⁷
- 2.8 Most micro-businesses are structured as sole proprietorships. Of the 4.5 million businesses with between 0 and 9 employees, 66% are sole proprietorships, 23% are companies and 11% are partnerships. Most small businesses are structured as companies. There are 0.2 million businesses with between 10 and 49 employees of which just 8% are sole proprietorships, 77% are companies and 15% are partnerships.⁸
- 2.9 Many entrepreneurs who run small or micro-businesses are relatively young. 25% are 25 or younger, 46% are 35 or younger. 5.5% of entrepreneurs have no educational qualifications at all. 30% have no educational qualifications beyond those gained at secondary school.⁹ Many of these entrepreneurs work alone without employees.
- 2.10 Thus most businesses are very small, with fewer than 10 employees. These micro-businesses are an important part of the UK economy but are unlikely to have specialised knowledge of insurance.

⁶ BERR, Table 1, UK Private Sector, <http://stats.berr.gov.uk/ed/sme/>.

⁷ BERR, Table 4, UK Industry Summary, <http://stats.berr.gov.uk/ed/sme/>. The BERR statistics do not distinguish between businesses that have few employees because work is subcontracted and those that do not subcontract. The statistics also do not give separate figures for business with between 0 and 9 employees and business with between 10 and 49 employees.

⁸ BERR, Table 3, UK Legal Status, <http://stats.berr.gov.uk/ed/sme/>.

⁹ Figures are taken from Small Business Service *Small Firms: Big Business*, chapter 3 (Characteristics of Entrepreneurs). 5.5% have no educational qualifications, 30.4% have not gone beyond secondary school, 32.6% have had some vocational training, 16.5% have a first degree and 15% have a postgraduate degree.

Small and micro-businesses: insurance

Buying insurance

2.11 In 2007, CRA International was commissioned by the FSA to examine commission transparency in the insurance market. In order to compile their report, CRA carried out a survey of how commercial customers bought insurance. They defined micro enterprises as those with an annual turnover of less than £500,000. They found that these customers accounted for around £3 billion of gross written premiums, or 17% of the market.¹⁰

2.12 All employers must purchase compulsory forms of insurance, such as employer's liability insurance. Although businesses can purchase each of their insurance policies separately, in practice CRA found that the majority buy employer's liability and public liability through a combined policy which also covers a range of other risks ranging from property to product liability. They calculated that a typical business with a turnover of between £50,000 and £500,000 spent between 1.2% and 1.3% of its turnover on insurance.

2.13 CRA also looked at the way in which businesses bought their insurance. In the survey they conducted with companies with an annual turnover of less than £500,000, they found that:

the purchase of insurance is not undertaken by risk specialists but it is rather a component of another role (most likely the owner-manager). The result is that these clients are also the least financially sophisticated.¹¹

2.14 These businesses are also the least likely to use brokers. The CRA report found that around 50% of those companies with turnover of less than £500,000 bought insurance directly from insurers.¹²

Most of the large insurance companies have a direct offering to small companies which they state has both grown in recent years and is also expected to continue to grow in the future. In part the development of low cost distribution via the internet and low cost automated underwriting is behind this trend as well as changing behaviour from clients who are increasingly willing to use internet distribution methods for accessing commercial insurance policies because they use similar distribution methods for their personal insurance needs.¹³

2.15 CRA quoted statistics showing that around 11% of insurance was sold directly to businesses through the internet in 2007 and

¹⁰ CRA International, *Commercial insurance commission disclosure: Market failure analysis and high level cost benefit analysis*, 5 December 2007.

¹¹ CRA International, *Commercial insurance commission disclosure: Market failure analysis and high level cost benefit analysis*, 5 December 2007, para 5.1.

¹² Above, para 4.3.1.

¹³ Above, para 3.4.6.

within the micro-enterprise and SME channel, some insurers operating in this market believed that there was scope for this to increase to as high as 20-25% of the market over the next few years.¹⁴

- 2.16 They found that, in response to this trend, some brokers and intermediaries have already chosen to withdraw from the micro-business sector as their clients become increasingly price driven and the direct channel forms a viable alternative. They expected that this withdrawal of intermediaries from the micro-business market would continue.

The Financial Ombudsman Service

- 2.17 The Financial Ombudsman Service (FOS) can hear complaints against insurers from businesses, but only if that business has a turnover of less than £1 million at the time of the complaint to the FOS. The FOS can only make binding awards against insurers of amounts up to £100,000.
- 2.18 On 9 April 2008, the Hunt Review of the FOS recommended a further review of the FOS' jurisdiction and compensation limits. It felt that the further review should consider whether the current jurisdiction limit of £1 million turnover for small businesses and the £100,000 limit on binding awards should be increased.¹⁵
- 2.19 The FOS will often treat a qualifying business as if it were a consumer. In the issue of Ombudsman News from December 2008/January 2009 the FOS stated its policy:

It is generally accepted within the insurance industry that claims brought by some smaller businesses should be handled in the same way as if they had been brought by a consumer. 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.¹⁶

¹⁴ Above, para 3.4.6.

¹⁵ The Hunt Review. *The Independent Review of the Financial Ombudsman Service: Opening Up, Reaching Out and Aiming High. An Agenda for Accessibility and Excellence in the Financial Ombudsman Service*, 9 April 2008, para 8.4.

¹⁶ Ombudsman News, Issue 74.

- 2.20 It appears, however, that relatively few small businesses actually bring claims to the FOS. We carried out a sample of 197 FOS cases for our Consultation Paper¹⁷ and found that only 4% of our sample was brought by businesses. We therefore asked the FOS if they could locate another 30 final decisions on non-disclosure by small businesses. In the end, however, they were only able to locate another 5 small business decisions relating to non-disclosure, making a sample of 12 cases in total. In the issue of Ombudsman News for December 2008/January 2009¹⁸ the FOS stated that only around 2% of complaints referred to it came from businesses, although they felt that this figure may be underestimated as some businesses may not register their complaint as a “business” dispute.¹⁹
- 2.21 We do not know why so few small businesses bring claims to the FOS but one of the factors could be that small businesses are not aware that they have the right to take complaints to the FOS. In contrast with the position for consumers, the FSA Handbook does not require insurers to tell businesses whose claims have been refused that they have a right to take a complaint to the FOS.²⁰
- 2.22 We would support an amendment to the FSA Handbook so that insurers are required to tell businesses whose claims have been refused that, if they have a turnover of less than £1 million, they have right to take a complaint to the FOS.

Conclusion

- 2.23 Micro-businesses are a crucial part of the UK economy. Micro-businesses form over a fifth of the UK private sector economy in terms of annual turnover and provide employment for nearly a third of the UK’s private sector working population. These businesses are increasingly buying their insurance online and directly from insurers. They usually do not have any employees who are risk specialists and there is some evidence that brokers appear to be withdrawing from this market.
- 2.24 The evidence indicates that many micro-businesses are in a similar position to consumers when it comes to buying insurance. Two-thirds of micro-businesses, after all, are sole proprietors. Businesses made a similar point when responding to our Consultation Paper. The Royal Institution of Chartered Surveyors wrote:

¹⁷ Insurance Contract Law: Misrepresentation, Non-disclosure and Breach of Warranty by the Insured (2007) Law Commission Consultation Paper 182; Scottish Law Commission Discussion Paper 134, Appendix C.

¹⁸ Ombudsman News, Issue 74.

¹⁹ Ombudsman News, Issue 74, p 17. “Sole traders and people running small businesses may not always register a complaint with us specifically as a *business* dispute. This is because they often see the issues as essentially personal rather than commercial. In practice, therefore, the proportion of complaints made by smaller businesses (around 2% of all complaints referred to us) may be slightly higher.”

²⁰ This is in contrast to the position for consumers. Insurers are required to tell consumers that they have a right to take a complaint about the insurer’s handling of their claim to the FOS by paragraph DISP 1.2.3(2) of the FSA Handbook. There is no equivalent provision for business policyholders.

Our membership will have both very sophisticated buyers and far less sophisticated buyers; all will be businesses. However, the latter, who more often than not will be sole practitioners, may be little more sophisticated than “consumers”.

PART 3

PROPOSALS IN THE CONSULTATION PAPER

CONSULTATION PAPER

- 3.1 In our Consultation Paper in July 2007¹ we argued that less sophisticated businesses needed more protection than other businesses. Our default regime of business insurance law was not compulsory; parties could contract out. However, we ensured that those terms which were contracted out of the default regime would be specifically brought to the attention of unsophisticated businesses.
- 3.2 Instead of determining the sophistication of a business by size, we designed a test that looked at how the business entered into the contract of insurance. Less sophisticated businesses are more likely to buy standard-form, mass-market insurance and they do not negotiate terms. We therefore proposed to prevent an insurer from contracting out of the terms of any new Act to the detriment of the business where the contract was:
- (1) on the insurer's standard set of terms; and
 - (2) if the particular terms had not been properly brought to the policyholder's attention (and therefore did not meet its reasonable expectations).

RESPONSES

- 3.3 Our intention was to limit the extra controls to situations in which the policy was written on an insurer's set of standard terms. It would not cover cases where the terms were put forward by a broker, or where the policy was composed of a "pick and mix" set of terms, even if each of the terms used had been used before. However, respondents often misinterpreted what we meant by standard terms. Many responded to say that it would be impossible for an insurer to write a contract without including a large proportion of standard terms and, even if it were amended or negotiated, the clauses added as a result would also normally be standard term endorsements. We did not intend it to include contracts which were put together through negotiation in this way.
- 3.4 However, there were two main drawbacks to our policy. The first was that it is difficult for an insurer to know when it has concluded enough contracts on a particular set of terms for it to become a standard form contract. This could produce uncertainty. The second drawback was that, if it is difficult for the insurer to know when a contract has become standard, it is even more difficult for the policyholder to know whether it has bought a standard form contract. Both parties could be unclear about their rights and obligations.
- 3.5 We have therefore concluded that a test for contracting out of the default regime that asks whether the contract is written on standard terms will not work efficiently to limit the controls to mass-market, off-the-shelf insurance products aimed at unsophisticated businesses.

- 3.6 In our Consultation Paper response sheet we asked consultees to tick one of three options for each of our proposals; agree, disagree or other. In relation to standard terms, most consultees wrote comments criticising or asking questions about the tests we proposed. Despite this widespread criticism, however, nearly half of the consultees ticked the box to say that they agreed with our proposal.² This suggests to us that a significant number of consultees agreed with the aim behind the reform; that is that there is a case for affording more protection to unsophisticated businesses, even if they disagreed with the specific tests we proposed.

CONCLUSION

- 3.7 The conclusion we reached from this was that protecting micro or small businesses by means of a standard terms and reasonable expectations test would not provide enough certainty for insurers or policyholders. However, many consultees believe that the existing law is not suitable for unsophisticated businesses

¹ Insurance Contract Law: Misrepresentation, Non-disclosure and Breach of Warranty by the Insured (2007) Law Commission Consultation Paper 182; Scottish Law Commission Discussion Paper 134.

² As above, paras 12.38 and 12.39.

PART 4

PLACING MICRO-BUSINESSES IN THE CONSUMER REGIME

OUR PROPOSAL

- 4.1 Using the evidence shown in Part 2 of this Paper and the consultation responses described in Part 3, we have reconsidered how to identify and protect unsophisticated businesses.
- 4.2 We have concluded that the best way of doing this would be to place micro-businesses in the consumer regime for the purposes of pre-contractual information.
- 4.3 Most micro-businesses are hardly, if at all, more sophisticated than consumers. Most are sole proprietorships, have relatively small turnovers and have no more experience in buying insurance than consumers. Insurers are increasingly selling directly to such customers and intermediaries are withdrawing from this market.¹ In some circumstances, micro-businesses are already treated as consumers by the FOS and we believe that the law should reflect the similar nature of micro-businesses and consumers. By contrast larger enterprises often have either specialised insurance departments or substantial relationships with brokers.
- 4.4 An advantage of placing micro-businesses within the consumer regime for pre-contractual information is that it would enable a consistent approach to be taken to the rest of the insurance market. Removing the consumer-like micro-businesses from the business regime would enable a more satisfactory balance to be reached between the interests of remaining policyholders and their insurers.

THE EFFECT OF TREATING MICRO-BUSINESSES AS CONSUMERS

- 4.5 We discuss our proposals relating to consumers in our Consultation Paper,² and in the summary of responses to that paper.³ The main difference between our proposals for consumer insurance and for business insurance is that consumers would no longer be under a duty to volunteer information for which they have not been asked. Instead, consumers would only need to answer the questions asked of them by insurers.
- 4.6 Where a consumer gives an insurer inaccurate information, our proposals would distinguish between three types of misrepresentation.
 - (1) Where the consumer acted deliberately or recklessly, the insurer would be entitled to avoid the policy and refuse to pay a claim.

¹ See paras 2.14 to 2.16, above.

² Insurance Contract Law: Misrepresentation, Non-disclosure and Breach of Warranty by the Insured (2007) Law Commission Consultation Paper 182; Scottish Law Commission Discussion Paper 134.

³ Reforming Insurance Contract Law, A Summary of Responses to Consultation (May 2008), Consumer Issues.

- (2) Where the consumer acted negligently in making the misrepresentation, the insurer would have a proportionate remedy. This looks at what the insurer would have done had it known the true facts. For example, if the insurer would have imposed an exclusion, the policy would be treated as including that exclusion. If the insurer would have charged more, the consumer would only receive a proportion of his or her claim.
 - (3) Where a consumer acted reasonably, the insurer would be required to pay the claim in full.
- 4.7 Crucially, we proposed that, when dealing with consumers, insurers should not be allowed to contract out of these proposals so as to give themselves greater rights to reject claims because of inaccurate information. Our proposals would apply even if a consumer “warranted” that information was true, or signed a statement that answers formed “the basis of the contract”.
- 4.8 By contrast, under our proposals for business insurance, businesses would still be under a duty to disclose information in some circumstances without being asked for it. Furthermore, our proposals would allow a high degree of party autonomy. A business policy could include terms to give insurers greater rights to reject claims for misrepresentation.

SMALL BUSINESSES

- 4.9 There may be concern that our proposal to place micro-businesses in the consumer regime does not protect small businesses sufficiently. Small businesses are usually defined as those with between 10 and 49 employees and some may consider that businesses of this size also need extra protection. We have, however, decided against proposing that small businesses be placed within the consumer regime. We believe that the consumer regime is less suitable for small businesses, especially those that have close to 50 employees. Small businesses are usually set up as companies and may have had legal advice when doing so. They will also have more sophisticated methods of accounting and administration than micro-businesses and are more likely to use brokers when buying insurance. Using figures provided by National Statistics it can be calculated the average turnover of a business with between 10 and 49 employees is £2,457,800 whereas the average turnover of a business between 1 and 9 employees is £405,400.⁴ Businesses with turnovers of £2.5 million are more likely to take professional advice, including when buying insurance.
- 4.10 We think that the consumer regime is unsuitable for small businesses. We could have proposed a separate scheme for small businesses in addition to a consumer regime and a large business regime. However, consultees indicated in their responses to Issues Papers 1 and 2⁵ that they were not keen on a complicated system of divisions between different sizes of business. We agree.

⁴ Averages calculated from figures in BERR, Table 1, UK Private Sector, number of employees divided by number of enterprises, <http://stats.berr.gov.uk/ed/sme/>.

⁵ Insurance Contract Law, Issues Paper 1, Misrepresentation and Non-disclosure (September 2006) and Insurance Contract Law, Issues Paper 2, Warranties (November 2006).

- 4.11 We therefore suggest that micro-businesses are sufficiently similar to consumers to be placed in the consumer regime for the purposes of pre-contractual information whereas small businesses would be better left in the business regime.
- 4.12 **We provisionally propose that micro-businesses should be treated as consumers for the purposes of pre-contractual information.**
- 4.13 **We provisionally propose that small businesses should be treated as businesses for the purposes of pre-contractual information.**

PART 5

UNFAIR TERMS

INTRODUCTION

- 5.1 Since 1994 consumers have had legal protection against unfair terms in insurance contracts. These protections were required by the 1993 European Directive on Unfair Terms,¹ and are implemented by the Unfair Terms in Consumer Contracts Regulations 1999 (UTCCR). However, neither micro-business policyholders nor other business policyholders have these rights to challenge unfair terms in an insurance contract before a court.²
- 5.2 In previous Parts of this Paper we have argued that micro-businesses tend to be unsophisticated customers who often buy insurance through the same channels and with the same level of knowledge as consumers. The logic of this argument suggests that micro-businesses should be given the same sort of protection as the UTCCR provides to consumers.
- 5.3 This proposal is for an extension of protection for micro-businesses in the context of insurance contracts only. It would mean that whilst their protection in the field of insurance would be brought into line with that of consumers, in other fields, for example, banking, it would not. We appreciate that the unique extension of the UTCCR to insurance contracts and the possibility that this may set a precedent may cause concern.
- 5.4 However, extending UTCCR protection to micro-businesses would be a development of existing trends rather than a revolution. Micro-businesses may already take disputes about policy terms to the Financial Ombudsman Service (FOS), who will decide the case according to what is fair and reasonable in the circumstances.³ As we discussed in the Consultation Paper, the FOS apply the spirit of the UTCCR in deciding consumer cases, and they are increasingly taking a similar approach to micro-business cases. Furthermore, insurers already have an obligation to treat their customers fairly, under the Financial Services Authority's rules.⁴ The advantage of extending UTCCR protection is that it would give a legal framework for these developments, and would allow for the same legal outcomes before both the courts and the FOS.
- 5.5 In this Part, we start by providing an outline of the Regulations. We then look at the broader effect of extending the UTCCR to small businesses, and look at the policy arguments both for and against extending protection in this way. We have not come to a firm conclusion on this issue, but would welcome views.

¹ Directive 93/13/EEC of 5 April 1993 on Unfair Terms in Consumer Contracts. This was originally implemented by Regulations in 1994, but these were then superseded by the Unfair Terms in Consumer Contracts Regulations 1999, which give preventive powers to bodies other than the Office of Fair Trading.

² UTCCR 3(1). The Regulations only apply to a natural person acting for purposes which are outside his trade, business or profession.

³ Financial Services and Markets Act 2000, s 228(2).

⁴ Financial Services Authority Handbook, High Level Standards, Principle 6.

THE UTCCR: AN OUTLINE

- 5.6 The UTCCR gives consumers protection against unfair terms in two ways. They state that all terms should be in plain and intelligible language and second that some terms can be assessed for fairness and, if they are found to be unfair, a party cannot rely on them. These are discussed below.

All terms to be in plain and intelligible language

- 5.7 The UTCCR states that every term within a consumer contract should be drafted in “plain and intelligible language”. Regulation 7(2) provides that:

If there is doubt about the meaning of a written term, the interpretation which is most favourable to the consumer shall prevail.

- 5.8 To a considerable extent, this reflects the common law position. There are many statements that, in insurance contracts, any ambiguity should be resolved in favour of the insured.⁵

Some terms can be assessed for fairness

- 5.9 The fairness provisions are more complicated. The UTCCR allows a court to assess any term within a consumer contract for fairness, unless it falls within one of three exemptions. The term must not be individually negotiated;⁶ it must not reflect mandatory statutory or regulatory provisions, or principles of international conventions;⁷ and it must not be a “core term” (see below).
- 5.10 The UTCCR divides the terms of a contract into what are usually referred to as core and non-core terms. Core terms are those that define:
- (1) the main subject matter of the contract or
 - (2) the adequacy of the price or remuneration as against the goods or services supplied in exchange.⁸
- 5.11 The exception for core terms is complicated because whilst core terms cannot be assessed for fairness, core terms that are not expressed in plain intelligible language can fall foul of Regulation 7(2).
- 5.12 In our 2002 Joint Consultation Paper on Unfair Terms in Contract,⁹ we commented that:

⁵ See, in particular, *Provincial Insurance Co v Morgan* [1933] AC 240.

⁶ UTCCR 5(1).

⁷ UTCCR 4(2).

⁸ UTCCR 6(2).

⁹ Law Com Consultation Paper No 166; Scottish Law Com Discussion Paper, No 119.

The reason for not subjecting [core terms] to review is that consumers will generally be aware of the terms in question and (provided they are in plain and intelligible language) understand them. Therefore, consumers are unlikely to be taken by surprise and also the terms will be subject to ‘the discipline of the market’. Consumers are much less likely to take into account terms which will only apply in certain circumstances (whether or not these circumstances involve a default) and accordingly these terms should be subject to review.¹⁰

- 5.13 In *Abbey National v Office of Fair Trading*, the Court of Appeal commented that this passage was “of considerable assistance” in identifying the correct approach to the definition of a core term.¹¹

What is a core term in an insurance contract?

- 5.14 There has been some debate about which terms in an insurance contract would qualify as core terms, which we discuss at length in the Consultation Paper on insurance law.¹² A policy term which defines or circumscribes the insured risk may qualify as “the definition of the main subject matter of the contract”.¹³ However, as stated above, it is only exempt from review “in so far as it is in plain intelligible language”.
- 5.15 The requirement for “plain intelligible language” should be interpreted in a broad, practical way. At first instance, in the *Abbey National* case,¹⁴ Mr Justice Andrew Smith said that the issue was whether the contractual terms are “sufficiently clear to enable the typical consumer to have a proper understanding of them for sensible and practical purposes”.¹⁵ Both parties accepted this test, which was not an issue in the appeal.
- 5.16 The focus on whether a typical customer would understand the term suggests that the courts should not only look at the language used but also on the format and legibility of the document. A term may not be understandable if it is hidden in tiny print, or printed in grey on blue. This view is given support by recital 20, which states that the consumer “should actually be given an opportunity to examine all the terms”.

¹⁰ Above, para 3.32.

¹¹ [2009] EWCA Civ 116, at para 79.

¹² Insurance Contract Law: Misrepresentation, Non-disclosure and Breach of Warranty by the Insured (2007) Law Commission Consultation Paper 182; Scottish Law Commission Discussion Paper 134, para 2.73 to 2.102.

¹³ See in particular, recital 19 to Directive 93/13/EEC of 5 April 1993 on Unfair Terms in Consumer Contracts.

¹⁴ [2008] EWHC 875 (Comm).

¹⁵ Above, at para 119.

- 5.17 On the other hand, in the *Abbey National* case, the Court of Appeal commented that the “typical customer is reasonably well-informed and reasonably observant and circumspect” and is also “taken to read the relevant documents and to seek to understand the contractual terms from that reading”.¹⁶ Presumably there comes a point at which a contract is so long, so badly laid out and so illegible that the reasonably circumspect customer cannot be expected to have read it, but it is not clear at which stage that point is reached.
- 5.18 The European Commission is currently reviewing the Unfair Terms Directive as part of a review of all eight main consumer protection directives. In October 2008, the Commission proposed a new directive on consumer rights, which expanded the concept set out in recital 20. The new draft states that for a term to be a core term it must be “transparent”. This means that terms must not only be in plain, intelligible language. They must also be legible and “made available to the consumer in a manner which gives him a real opportunity of becoming acquainted with them before the conclusion of the contract”.¹⁷ This makes explicit some effects which are not wholly clear in the current version of the Directive.

The test of fairness

- 5.19 Once it has been established that a term has not been individually negotiated, does not reflect mandatory statutory or regulatory provisions, or principles of international conventions, and is not a “core term”, it can then be assessed for fairness.
- 5.20 Under Regulation 5(1), a term is said to be unfair if
- contrary to the requirement of good faith, it causes a significant imbalance in the parties’ rights and obligations arising under the contract, to the detriment of the consumer.
- 5.21 Although this test is expressed in somewhat “European” language, it is interpreted in a general way. It allows the courts to look both at procedural issues (such as the way the term was brought to the consumer’s notice) and the substantial effect of the term. As Lord Bingham put it in *Director General of Fair Trading v First National Bank plc*:

The requirement of good faith in this context is one of fair and open dealing. Openness requires that the term should be expressed fully, clearly and legibly, containing no concealed pitfalls or traps. Appropriate prominence should be given to terms which might operate disadvantageously to the consumer. Fair dealing requires that a supplier should not, whether deliberately or unconsciously, take advantage of the consumer’s necessity, indigence, lack of experience, unfamiliarity with the subject matter of the contract, weak bargaining position....¹⁸

¹⁶ *Abbey National and others v Office of Fair Trading* [2009] EWCA Civ 116, at para 117.

¹⁷ Proposal for a Directive on Consumer Rights, COM (2008) 614/3, 08.10.2008, art 31.

¹⁸ [2001] UKHL 52, [2002] 1 AC 481 at [17].

5.22 The general nature of the test is reinforced by Regulation 6(1). This states that the unfairness of a contractual term shall be assessed taking into account not only the nature of the goods and services but also:

all circumstances attending the conclusion of the contract and to all the other terms of the contract or of another contract on which it is dependent.

5.23 In order to provide greater detail of what this test means, the Directive provides an “indicative and non-exhaustive list of terms which may be regarded as unfair”, known colloquially as the “grey list”. The list has no clear status: a term on the list may be fair, while a term not on the list may be unfair. However, it is intended as an illustration. It includes, for example,

(i) irrevocably binding the consumer to a term with which he had no real opportunity of becoming acquainted before the conclusion of the contract; and

(j) enabling the seller or supplier to alter the terms of the contract unilaterally without a valid reason which is specified in the contract.

5.24 However, many of the terms on the grey list are more applicable to sales contracts than insurance contracts, and the list has not been drafted with insurance contracts in mind.

5.25 It is worth noting that under the Regulations, the fairness of a term must be assessed at the time the contract was made. The court cannot look at circumstances which took place after the contract was concluded. Thus the test may not take account of the fact that the term was applied in an unfair way. As Lord Hope pointed out in *Director General of Fair Trading v First National Bank plc* a term may be fair even if the consequences “must still come as a nasty shock” to consumers.¹⁹

5.26 However, as we discuss in relation to warranties in Part 6 below, where a contract sets out unfair consequences for the breach of the term, the consequences may be considered a term in their own right.

The result of finding that a term is unfair

5.27 Regulation 8 provides that, if a term is found to be unfair, “it shall not be binding on the consumer”.²⁰ However, the rest of the contract continues to bind the parties “if it is capable of continuing in existence without the unfair term”.²¹

¹⁹ [2001] UKHL 52, [2002] 1 AC 481 at [59].

²⁰ UTCCR 8(1).

²¹ UTCCR 8(2).

5.28 As we discussed in our 2005 report on Unfair Terms in Contracts,²² the court may not re-write the term so that it is fair. However a term might be in distinct parts, so that part of the clause may remain binding while part is struck out.²³ The policy behind Regulation 8 is to save as much of the contract as can be saved, without the unfair term.

Preventive powers

5.29 A major innovation in the 1994 Regulations was that enforcement was not left to the parties alone. Instead, the Director General of Fair Trading was empowered to bring proceedings for an injunction or interdict against suppliers who used unfair terms. In 1999, the list of enforcement organisations was extended, and in 2001 the Financial Services Authority (FSA) was added. The FSA is now the organisation primarily responsible for preventing insurers from using unfair terms in their contacts with consumers.²⁴ The FSA works through negotiation and agreement, backed by the sanction of possible court action.

5.30 The FSA publishes its findings on unfair terms in insurance contracts on its website.²⁵ Since 2004 there have been 12 findings against insurers. Recent findings have been made against insurers for using unclear language in exclusion clauses²⁶ and for unfair notice provisions.²⁷

WHAT TERMS IN AN INSURANCE CONTRACT WOULD BE COVERED?

5.31 The UTCCR already covers all non-negotiated terms of consumer insurance contracts except core terms. We ask whether its protection should be extended to micro-business insurance contracts. The following are examples of the clauses that might be covered.

- (1) *Risks which are defined in an apparently broad way at the front of the policy document, but then made subject to much narrower definitions in the small print.* An example would be where a policy spoke about “storm damage” in the first five pages and in all the accompanying documents, but on page 72 defined a storm as meaning a Force 10 gale or above.

²² Unfair Terms in Contracts (2005) Law Com No 292; Scot Law Com No 199.

²³ Unfair Terms in Contracts (2005) Law Com No 292; Scot Law Com No 199, para 3.136.

²⁴ See Concordat between OFT and FSA, set out in OFT, Unfair Contract Terms Bulletin 16, December 2001.

²⁵ <http://www.fsa.gov.uk/pages/Doing/Regulated/consumer/relevant/index.shtml> .

²⁶ In September 2008 the FSA declared that an exclusion clause that read “you are not covered for anything caused directly or indirectly by consequential loss of any kind” was not in clear and intelligible language and in addition, it was so unclear and ambiguous that it may have been unfair. The insurers had to replace it with “we will not pay for any losses that are not directly associated with the incident that caused you to claim. For example, loss of earnings due to being unable to return to work following injury or illness happening whilst on a trip or the cost of replacing locks in the event that keys are lost whilst on a trip”.

²⁷ In July 2008 the FSA declared that a clause that required policyholders to give notice of the loss or theft of a mobile phone within 48 hours of the loss or theft was unfair. The insurance company changed the clause so that policyholders have 48 hours from discovery of the loss or theft of a phone to contact their insurer.

- (2) *Exclusions which appear narrow but which are unexpectedly broad.* An example would be an exclusion for “riot”. The term “riot” has been held to follow the strict criminal law, which includes 12 people or more acting with a common purpose, using unlawful violence or the threat of unlawful violence.²⁸ It might include a robbery, terrorist bomb or hijacking, which is much broader than most people would understand by the term.
- (3) *Unduly onerous notification clauses.* For example, the FSA has taken action against a consumer contract which purported to provide cash-back, but only if the policyholder submitted numerous forms within strict time limits.
- (4) *Premium variation clauses.* Again the FSA has taken action against a term which permitted the insurer to increase the premium for long-term protection insurance without giving reasons for the changes.
- (5) *Warranties of future conduct.* This is discussed in more detail in Part 6 below.

5.32 The fact that the UTCCR covers such a wide variety of terms has both advantages and disadvantages. The main advantage is that it avoids technical arguments about the true classification of the term. Such arguments have dogged discussions of warranties in the UK. In Australia, section 54 of the Insurance Contracts Act 1984 attempts to set out the types of term to which a causal connection test should apply, and has also led to considerable litigation.²⁹ Furthermore, the UTCCR contains a flexible test which meets the needs of a changing market place.

5.33 The disadvantage is one of potential uncertainty. Neither policyholders nor the insurers are granted certainty over what might or might not constitute an unfair term. For consumer sale and supply contracts, illustrations are provided by the “grey list”. We think it might be helpful if similar guidance were provided specifically within the context of insurance to micro-businesses. Such guidance need not be in the statutory form, but could be issued from time to time by the FSA.

SHOULD MICRO-BUSINESSES BE GIVEN UTCCR TYPE PROTECTION? THE POLICY ARGUMENTS

5.34 Having looked at how the UTCCR works, we return to the policy arguments for and against extending their effect to micro-businesses.

²⁸ See *Motor Union Insurance Co Ltd v Boggan* (1923) 130 LT 588: for discussion, see M Clarke, *The Law of Insurance Contracts* (2002) para 19-3E. The threat of violence must be “such as would cause a person of reasonable firmness present at the scene to fear for his personal safety”.

²⁹ For discussion of this point, see Issues Paper 2, paras 6.25 to 6.41; and *Insurance Contract Law: Misrepresentation, Non-disclosure and Breach of Warranty by the Insured* (2007) Law Commission Consultation Paper 182; Scottish Law Commission Discussion Paper 134, paras 8.21 to 8.45. See also paras 6.16 onwards of this Paper for further discussion of warranties and the causal connection test.

- 5.35 The main argument against extension is that the standards within the UTCCR are not as certain as they could be. It could therefore introduce uncertainty. However, this could be substantially reduced by appropriate guidance issued by the FSA. We also acknowledge that it may be difficult for small businesses to formulate their arguments under the UTCCR. However, if the FSA is given preventive powers, the onus would no longer be on micro-businesses themselves.
- 5.36 The main argument in favour of extension is that if we have decided that micro-businesses are as unsophisticated as consumers, then it follows that they should be given the same protection. If they are not, we will end up with three legal regimes; one for consumers, one for micro-businesses and one for large businesses. This would be confusing for all parties and we have been told by consultees that more than two regimes of insurance law would be too complex.
- 5.37 In addition, UTCCR principles are already being applied to the micro-business cases. Micro-businesses may already take disputes about policy terms to the FOS, and insurers already have an obligation to treat their customers fairly, under FSA rules. We think that extending the UTCCR would give a legal framework to these developments. It would permit the courts to do the same kind of justice as the FOS in these cases. It would also enable all parties to understand more about the basis on which the FOS and the FSA might make their decisions.
- 5.38 We therefore ask consultees for their views on extending UTCCR protection to small businesses.
- 5.39 **Should the provisions of the Unfair Terms in Consumer Contracts Regulations 1999 be extended to micro-businesses for the purposes of insurance contracts?**

PART 6

THE PROBLEM OF WARRANTIES OF FUTURE CONDUCT

INTRODUCTION

- 6.1 As stated in paragraph 5.31(5) above, in this Part we look in more detail at the application of the Unfair Terms in Consumer Contracts Regulations 1999 (UTCCR) to warranties of future conduct in particular. As we will demonstrate, it is cumbersome and so we ask what should be done to improve protection in this area.

WARRANTIES OF FUTURE CONDUCT IN MICRO-BUSINESS CONTRACTS

- 6.2 In the Consultation Paper¹ we discuss the problems associated with warranties of future conduct. The consequence of a breach of warranty in an insurance contract is that the insurer is discharged from all liability under the contract. This is the case even where the policyholder has remedied the breach or where the loss suffered bears no relation to the breach of warranty. This can be unfair.
- 6.3 If, for example, an insured business warrants that it will maintain a burglar alarm and fails to do so, it seems fair that the insurer need not pay a claim for a burglary which has been made easier by the lack of an alarm. However, it may be unfair for the insurer to deny an unconnected claim for flood damage. Similarly, it would be unfair to turn down a claim when the burglary took place only after the alarm had been repaired.
- 6.4 In practice, warranties are rarely used in consumer contracts, but they are used in micro-business contracts. For our 2007 Consultation Paper, we researched a sample of ombudsman final decisions, including 50 consumer disputes and 18 small business disputes about policy terms. None of the consumer disputes involved a warranty within the strict meaning of the word. However, we found several disputes brought by micro-businesses about warranties. A Chinese restaurant brought a case about a warranty that woks should not be left unattended; a pub disputed warranties over how a deep fat frying range should be cleaned; and self-employed builders disputed “application of heat” warranties. We did not find any cases in which an insurer relied solely on a breach of warranty to reject a claim which was not causally connected to the breach. However, one insurer did run such an argument to support its decision to reject a claim which had been made mainly on other grounds.

¹ Insurance Contract Law: Misrepresentation, Non-disclosure and Breach of Warranty by the Insured (2007) Law Commission Consultation Paper 182; Scottish Law Commission Discussion Paper 134.

HOW WOULD A WARRANTY OF FUTURE CONDUCT BE DEALT WITH UNDER THE UNFAIR TERMS IN CONSUMER CONTRACTS REGULATIONS 1999?

- 6.5 This leads to questions about how warranty of future conduct cases would be dealt with if UTCCR provisions were extended to micro-businesses. To illustrate the point, it may be helpful to begin with an example.
- 6.6 Suppose, for example, a small shopkeeper takes out an insurance contract which states:

Warranted: burglar alarm to be maintained in working order at all times: sections 33 and 34 of the Marine Insurance Act 1906 apply.

- 6.7 The burglar alarm develops a fault, which the shopkeeper succeeds in remedying. A burglary takes place when the alarm is in working order. The insurer rejects the burglary claim on the grounds that the warranty has been breached, pointing out that the fact that the breach has been remedied is irrelevant. Section 33(3) of the Marine Insurance Act 1906 states that a “warranty must be exactly complied with, whether material to the risk or not”. Section 34(2) goes on to say that:

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.

Analysis of the law

- 6.8 If the UTCCR were extended to micro-businesses, the court would need to consider the issue in stages.

- (1) *Is the meaning of the term open to doubt?* The first stage would be to interpret the term, bearing in mind that any ambiguity must be resolved in favour of the micro-business.² If the court finds that the term might apply only where the alarm was broken at the time of the burglary, then this is the way the term should be interpreted. The insurer would be required to pay the claim.

However, if the court found that the term was not ambiguous, so that it definitely did apply to breaches that had been remedied, it would need to proceed to Stage 2.

- (2) *Is the warranty a core term?* It might possibly be argued that the term defines the risk, and is therefore the main subject matter of the contract. If it is one of these core terms it cannot be assessed for fairness. However, the term is clearly not in plain, intelligible language. A typical small shopkeeper is unlikely to understand the effect of section 34 of the Marine Insurance Act 1906. This means that it falls within the exception and, even if it is a core term, it can be assessed for fairness under Stage 3.

² Under both Reg 7(2) and common law principles.

- (3) *Is the term fair?* This is a general test, looking at whether the term was “expressed fully, clearly and legibly, containing no concealed pitfalls or traps”, and weighing the legitimate interests of the insurer against the detriment to the consumer. In this case, the court may well conclude that the reference to “warranty” and to sections 33 and 34 constituted a “concealed pitfall”, causing detriment to the policyholder without being necessary to protect the legitimate interests of the insurer. Most policyholders will not understand the word warranty, especially not as it is used in the context of an insurance contract to mean a term, breach of which discharges the insurer from liability under the contract. They are likely to be confused by only knowing the word warranty in the context of “extended warranties” that are sold on household appliances. It is therefore likely that a court or the FOS would find the word “warranty” to be unfair in the same way as the FSA found the words “consequential loss” to be possibly unfair in September 2008.³
- (4) *How much of the clause constitutes the “unfair term”?* Having decided that the reference to the word “warranty” and to sections 33 and 34 is unfair, the court has to decide whether these words constitute a separate “term” which can cease to be binding on the consumer. As discussed above, we think that the court should look at each part of the clause separately, and, if practicable, delete only those words or phrases which are unfair. The rest of the contract should continue to exist. Thus in our example, it would be open to the court to preserve the words “burglar alarm to be maintained in working order at all times”, while deleting the words “warranty” and “sections 33 and 34 of the Marine Insurance Act 1906 apply”.
- (5) If the court went down this route, it could have the effect of removing the unfair consequences of the term. The term will be held to apply only in losses connected with the lack of an alarm, and the insurer would be obliged to pay the claim.

Mandatory statutory provisions

6.9 There is, however, a final argument that the insurer could use. As we stated at paragraph 5.9 above, under Regulation 4(2), the Regulations do not apply to contractual terms which reflect –

mandatory statutory or regulatory provisions (including such provisions under the law of any Member State...)

³ In September 2008 the FSA declared that an exclusion clause that read “you are not covered for anything caused directly or indirectly by consequential loss of any kind” was not in clear and intelligible language and in addition, it was so unclear and ambiguous that it may have been unfair.

- 6.10 Are sections 33 and 34 of the Marine Insurance Act mandatory statutory provisions, spelling out the specific consequences of a breach of warranty? If so, a contractual term which reflected them would not be open to challenge. We think that sections 33 and 34 are not mandatory provisions: insurers may decide whether or not terms have the effect of a warranty; and the effect which may be fair in some cases (for example, if a ship loses its classification) would be unfair in others.⁴ We think that an insurer who attempted to make this argument in a consumer context would be given short shrift.
- 6.11 However, the reason for Regulation 4(2) is that there is a strong presumption that statutory provisions are fair, and should not be open to challenge. If, as we argued in the consultation paper, we think that sections 33 and 34 have the potential to be unfair, there is an argument that they should be removed, at least in so far as they affect micro-businesses.

Conclusion on the UTCCR and warranties of future conduct

- 6.12 In our Issues Paper on warranties, we pointed out that the UTCCR had the potential to provide appropriate protection against warranties. However, as is clear from the paragraphs above, the effect is cumbersome.⁵ Policyholders must overcome several hurdles, in a multi-stage test. Few policyholders would be able to pursue these arguments without legal help.⁶
- 6.13 For the present purposes, we think that the UTCCR would give micro-businesses protection against the inappropriate application of warranties, but the effect would be clearer if it were combined with reform of sections 33 and 34 of the Marine Insurance Act 1906.

REFORM OF SECTIONS 33 AND 34 OF THE MARINE INSURANCE ACT 1906

- 6.14 Sections 33 and 34 of the Marine Insurance Act 1906 set out the following consequences for breach of warranty:
- (1) Section 33(3) states that “a warranty, as above defined, is a condition which must be exactly complied with, whether it be material to the risk or not. If it be not so complied with, then, 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”.
 - (2) Section 34(2) states that “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”.

⁴ There is also an argument that sections 33 and 34 are only statutory provisions in so far as they apply to marine insurance: see Insurance Contract Law: Misrepresentation, Non-disclosure and Breach of Warranty by the Insured (2007) Law Commission Consultation Paper 182; Scottish Law Commission Discussion Paper 134, para 2.5.

⁵ Issues Paper 2, Warranties, November 2006, para 4.74.

⁶ Although, as explained in para 5.29, if the FSA takes on preventive powers it could compel insurers to remove such terms from contracts.

- 6.15 We do not believe that these provisions are appropriate for warranties in consumer and micro-business insurance contracts. We therefore proposed in our Consultation Paper that these provisions should be disapplied. Instead, warranties should be subject to a causal connection test.

The causal connection test in our Consultation Paper

- 6.16 We proposed in the Consultation Paper that in both consumer and business insurance the policyholder should be entitled to be paid a claim if the policyholder can prove, on the balance of probability, that the event or circumstance constituting the breach of warranty did not contribute to that loss. Seventy-four consultees responded to this proposal and fifty-seven (77%) of them agreed that a causal connection test was desirable.
- 6.17 As we wrote in the Consultation Paper,⁷ it is necessary to confine the causal connection test to warranties in the narrow sense; that is, to terms by which the insured promises that a certain thing should or should not be done, or that some condition shall be fulfilled. The problem is that the word “warranty” is used carelessly in insurance contracts. As well as promises that certain things will be done (for example, “warranted: a burglar alarm shall be maintained”), the word warranty is also used when describing exceptions (“warranted: the car shall only be driven by those over 21”) and definitions of the risk (“warranted: the car shall not be used for commercial purposes”). A causal connection test would work well for the first example, but it would not work well when applied to exceptions or to definitions of the risk if insurers actually wanted these terms to delineate the scope of cover.
- 6.18 One of the aims of our proposal in the Consultation Paper was to encourage insurers to use the word warranty more carefully. A warranty discharges the insurer from all liability under the contract and, once it has been breached, the contract cannot be revived. If an insurer intended breach of a term to have such strict consequences then we did not think it was appropriate that they could achieve this simply by the use of the word warranty. Instead, we argued that they should describe the term as a limitation of cover, a condition precedent or an exclusion. If they described the term as a warranty, we thought that most consumers would not understand what the consequences of breach were. Therefore, we felt that it would be fair if insurers could only refuse to pay a claim where the loss was connected to the breached warranty.

⁷ Insurance Contract Law: Misrepresentation, Non-disclosure and Breach of Warranty by the Insured (2007) Law Commission Consultation Paper 182; Scottish Law Commission Discussion Paper 134, para 8.4.

Our proposal

- 6.19 We have seen above that it is likely that under the UTCCR a warranty that is not clearly brought to the policyholder's attention and does not contain a causal link between the breach and the loss will be found to be unfair. However, as we have demonstrated, policyholders have to make complicated arguments to reach that result.⁸ We therefore still think that applying a causal connection test to all terms described as warranties is a sensible idea and it has also received approval from consultees.
- 6.20 Adding an automatic causal connection test to all terms described as warranties will mean that if insurers want to draft exclusions or a limitation or a condition precedent⁹ they will need to do so more explicitly. If they simply use the word warranty then they will not be automatically discharged from liability on the breach. Instead, a causal connection test will apply. The causal connection test we propose is the same as the one proposed in our Consultation Paper.¹⁰
- 6.21 On top of this will be the UTCCR protections. If insurers do not spell out consequences of breach of the warranty clearly then they will be at risk of having the whole term set aside for unfairness under the UTCCR.
- 6.22 Both the causal connection and the UTCCR protection aim to provide the same result; namely that breach of a warranty will not discharge the insurer from liability unless the breach is causally connected to the loss. However, the causal connection test is more direct and therefore may be easier for both insurer and policyholder.
- 6.23 We have considered whether to apply a causal connection test to all warranties and not simply to terms described as warranties. However, we have decided against this course. Our main reason is that the definition of a warranty is too unclear. As we saw above, several different types of term may be used to prevent the insurer from being liable for a claim, even though the claim was not caused by the insured's breach. This point may be illustrated with an example:

A motor insurance policy states clearly that it only covers domestic use, but the insured uses the car in the course of a business. The car suffers from a fire while parked. The fire would have taken place whatever use had been made of the vehicle.

⁸ See para 6.8 above.

⁹ Under Scots law a condition precedent would be a suspensive condition.

¹⁰ Insurance Contract Law: Misrepresentation, Non-disclosure and Breach of Warranty by the Insured (2007) Law Commission Consultation Paper 182; Scottish Law Commission Discussion Paper 134, Part 8.

If the requirement that the car should only be used for domestic purposes is a definition of the risk or a condition precedent, then the insurer could refuse the claim. If, however, we were to introduce a causal connection test for all warranties, it would be open to the insured to argue that the term was a warranty, and therefore the insurer should pay the claim. The old arguments about the difference between a condition precedent, a definition of the risk and a warranty would return, but in a new form. We do not think this would be helpful. Nor do we think that such a reform would be necessary to do justice to the insured. If a term was clearly not central to the risk, and did not use the word warranty, then the courts would have no difficulty in interpreting it so that it that did not apply without a causal connection.

- 6.24 **We ask consultees whether, in addition to the UTCCR, a causal connection test is necessary for terms described as warranties which apply to future conduct in micro-business insurance contracts.**
- 6.25 **The causal connection test is the one as set out in the Consultation Paper, namely that a 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.**

PART 7

BASIC DEFINITION OF MICRO-BUSINESS

INTRODUCTION

- 7.1 If we are to place micro-businesses within the consumer regime then we need a workable definition of micro-business. This is a difficult task. We are keen to talk to insurers and businesses to find the more practicable solution for all parties to the question of definition.

Limit of our definition

- 7.2 In preliminary discussions, insurers have indicated concern that we were proposing a change to the definition of retail and consumer customers in general. This is not what we propose. Instead our definitions of micro-business and consumer would be used purely for the purposes of pre-contractual information and unfair terms in insurance contracts and the ambit of the definition would be limited to the provisions on these matters in the new Bill.
- 7.3 Our Paper proposes no changes to the Financial Services Authority Handbook. It is clear from the FSA Handbook that the distinction between consumer and commercial customer is (in some cases) relevant and we do not propose to alter this. The definitions as set out in that Handbook will continue to apply to the matters covered by the Handbook. So, for example, the provisions which apply to the Distance Marketing Directive rules in ICOBS 3 will only apply to consumers, as defined under the FSA Handbook. They will not be extended to micro-businesses.
- 7.4 Our Paper also proposes no changes to legislation other than in the areas covered in this Paper. It does not propose, for example, that a micro-business is to be treated as a consumer for the purposes of the Supply of Goods and Services Act 1982.

THE PROPOSED TESTS FOR DEFINING A MICRO-BUSINESS

- 7.5 We consider that, whatever test is used to define a micro-business, it should be one that is simple for both the business and the insurer. We discuss three options below and ask consultees to let us know which they would find the more practical.
- 7.6 Option 1 defines a micro-business by looking at its turnover and option 2 defines a micro-business by looking at the number of employees. Option 3 defines a micro-business by using the proposed new Financial Ombudsman Service jurisdiction limit.
- 7.7 We also discuss, but reject as being too complex, a fourth option which defines a micro-business by means of assets, turnover and number of employees together. For example, the BERR/European Commission test states that a micro-business must not only have 0-9 employees, but must also either have an annual turnover of less than €2 million or assets of less than €2 million.

- 7.8 Whether consultees prefer a turnover based definition or an employee based definition, it will also be necessary to apply a sophistication filter. This will prevent the definition of micro-businesses including, for example, project companies which are part of larger business structures, albeit with very few employees or limited turnover. Our proposals for sophistication filters are discussed in the next Part.

OPTION 1 – TURNOVER DEFINITION

- 7.9 It would be possible to identify a micro-business by using turnover assessed at the point at which the contract is made.
- 7.10 Some insurers have tentatively indicated to us that a straightforward turnover test would be the easiest way of identifying micro-businesses. It would be quick and easily understandable by policyholders and would only demand information that businesses have to gather in any event for other purposes. It is also information that insurers are used to asking businesses to supply. We therefore put it forward as a question and would be grateful for consultees' views on this method of identifying micro-businesses. Such an approach has the advantage of simplicity and consistency. However, a turnover test can be a crude measure.
- 7.11 First, there can be a delay between the micro-business' turnover figure being calculated and the policy being bought. A small company can choose its own financial year. If, for example, its year runs from 1 April 2006 to 31 March 2007, it would not have needed to file accounts until 31 January 2008.¹ That means it could have bought an insurance policy in early January 2009 using turnover figures mostly derived from 2006. Sole traders and partnerships will fill in annual returns, which have the same time-lag period.
- 7.12 The second problem with turnover tests is that they are biased in favour of those companies that provide services. A business that manufactures items or produces goods is likely to have higher turnover figures than a micro-business that sells services.² This would mean that those selling services could be much more likely to find themselves defined as a micro-business than those involved in agriculture, fishing, retail or manufacturing. As we saw above, many small businesses are involved in these sectors. We do not think this is a fair position.
- 7.13 Third, it will be difficult to find a turnover figure for brand-new start-up businesses, many of which should fall into the micro-business category. These businesses will need insurance before they start trading so they could not use turnover to date. It would, of course, be possible to use projected turnover but this could prove to be inaccurate.
- 7.14 Finally, it is difficult to find an appropriate turnover level. We can see three options, discussed in turn, below:

¹ This will change to a return date of 31 December for accounts that start on or after 6 April 2008, section 442 of the Companies Act 2006.

² Businesses that sell services generally have a lower turnover than those that manufacture or produce goods. This is because the value added in the former is typically a lower percentage of total sales than in the latter.

- (1) The Department of Business, Enterprise and Regulatory Reform (BERR) uses an annual turnover of less than €2 million as one of the signifiers of a micro-business. This level would be familiar to businesses in the UK and would be updated regularly. However, the fact that it is expressed in euros will cause difficulties. Should the sterling equivalent be calculated at the time the policy is bought, or at the time the turnover figure was calculated? As we saw above, there can be a significant time-lag between the two dates and at the time of writing, the sterling/euro exchange rate is not stable.³
 - (2) As an alternative, it would be possible to set the turnover test at the level of the current FOS jurisdiction limit. This is currently a turnover of less than £1 million although it may be set to rise and become more complicated.⁴ We discuss this further below.
 - (3) A final possibility is to pick an appropriate level independently of any other test. We believe that this would be less practical than tying the level to that of the FOS as it would need to be regularly updated. However, if consultees feel strongly that an independent limit would be appropriate we would be interested to hear their reasons and the level at which it should be set.
- 7.15 We therefore ask for consultees' views on whether a turnover test is suitable and, if so, what level it should be set at.
- 7.16 **Do consultees believe that a turnover test is sufficient to define a micro-business?**
- 7.17 **If so, do they agree that turnover should be assessed from the most recent accounts available at the time of entering into the contract (or from projected turnover in the case of a new start-up business)?**
- 7.18 **What level should the turnover definition be set at? Should it be:**
- (1) **tied to the level of the BERR turnover arm of its definition of a micro-business (currently €2 million); or,**
 - (2) **tied to the level of FOS jurisdiction (currently £1 million) assessed at the time the contract was entered into;**
 - (3) **set at an independent level which will need to be amended from time to time? If so, what should the level be?**
- 7.19 If a turnover test is to be used, a method will have to be designed to filter out those businesses that only have small turnovers because they are part of a larger group of companies. We discuss this in the next Part.

³ For example €2 million would have been £1.73 million on 5 December 2008 but on 31 March 2007 it would have been £1.36 million; a difference of £370,000.

⁴ See below, para 7.37.

OPTION 2 – EMPLOYEE DEFINITION

- 7.20 The second option is to define a micro-business by the number of employees it has, assessed at the time the contract was entered into. BERR and the European Commission describe micro-businesses as businesses that have fewer than 10 employees.⁵
- 7.21 Such an option was considered by the Law Commissions in their previous report on Unfair Contract Terms⁶ which concluded that a suitable definition for small business would be “a person in whose business the number of employees does not exceed nine”.⁷
- 7.22 The definition of employees given by BERR and the European Commission states that it should include employees as defined by national legislation *as well as owner managers and partners*.⁸ The staff headcount should be calculated in “full time equivalent” so part time staff, seasonal workers and those who did not work the full year should be treated as fractions of the annual unit. We believe that this is a sensible approach.
- 7.23 We do, however, need to decide on which definition of employee would be best. The most frequently applied definition appears in the Employment Rights Act 1996. This states that an employee is an individual who has entered into or works under a contract of employment.⁹ A contract of employment is defined as a contract of service or apprenticeship, whether express or implied.¹⁰ Case law then assists further with the definition.¹¹

⁵ The test in full is a business that has fewer than 10 employees and either an annual turnover or assets of less than €2 million.

⁶ Unfair Terms in Contracts (2004) Law Commission Report 292; Scottish Law Commission Report 199.

⁷ Unfair Terms in Contracts (2004) Law Commission Report 292; Scottish Law Commission Report 199, Appendix A, Draft Bill clause 27.

⁸ European Commission, Enterprise and Industry Publications, *The new SME definition User guide and model declaration*, para 2.2.1.

⁹ Employment Rights Act 1996, section 230(1). The section in full is “In this Act ‘employee’ means an individual who has entered into or works under (or, where the employment has ceased, worked under) a contract of employment”.

¹⁰ Employment Rights Act 1996, section 230(2). The section in full is “In this Act ‘contract of employment’ means a contract of service or apprenticeship, whether express or implied, and (if it is express) whether oral or in writing”.

¹¹ See Harvey’s *Employment*: paragraphs 1 to 150.1 for a full explanation of the definitions of employee.

- 7.24 There is a wider definition of a “worker” which is used in other statutes. Under the Working Time Regulations 1998, for example, a worker either works under a contract of employment, or under any other contract under which that worker performs personally any work or services, where the other party to the contract is not a client or customer of the worker’s profession.¹² The definition of worker therefore includes those who fail to establish a contract of employment, but would still exclude those that are clearly self-employed. Case law then assists further with the definition here too.¹³
- 7.25 A third option would be for the legislation to define a micro-business as a business that had had an average of fewer than 10 employees on its pay roll. This can either be calculated as an average over the preceding twelve months, or it could be tied to the employer’s annual return to HM Revenue & Customs (HMRC) on the P35 form.
- 7.26 This annual return option might be an easier definition for both businesses and insurers to work with as it would minimise any problems with the legal definitions of employees and workers. Given that the number of employees will be a representation by the business, neither insurer nor business will want, if the answer is wrong, to argue over whether it was an honest misrepresentation or not. If the definition of employee is not straightforward then there is a danger that the business’s representation on the number of employees it has will become an area of dispute. If, however, the question is tied to the payroll or the data on a P35, then there will be easily available documents from which the business can find the answer.
- 7.27 An employee-only test has many advantages and is a test commonly used by BERR to identify a micro-business. There are 4.5 million businesses with fewer than 10 employees in the UK. Yet, only 208,000 businesses have between 5 and 9 employees.¹⁴ There are also only 111,000 businesses with between 10 and 19 employees. This suggests that relatively few businesses have between 8 and 10 employees and for the vast majority of businesses and insurers, it will be very clear who is within the consumer regime and who is not.¹⁵
- 7.28 A test of employees would not have the same bias towards service businesses as a turnover test. A turnover test could penalise those that had to buy large amounts of raw materials or stock, whereas a test that looked at the number of employees would be fairer. It would also suffer from less of a time delay if the question were tied to the average number of employees according to the payroll over the twelve months immediately preceding the application for insurance cover.

¹² Trade Union Labour Relations (Consolidation) Act (TULRA) 1992 s230. The section in full is that a worker is “an individual who has entered into or works under or (where the employment has ceased) worked under (a) a contract of employment, or (b) any other contract, whether express or implied, and (if it is express) whether oral or in writing, whereby the individual undertakes to do or perform personally any work or services for another party to the contract whose status is not by virtue of the contract that of a client or customer of any profession or business undertaking carried on by the individual”.

¹³ See Harvey’s *Employment*, paragraphs 1 to 150.1 for a full explanation of the definitions of employee and worker.

¹⁴ 3.5 million businesses have no employees and 812,000 have between 1 and 4 employees.

- 7.29 There are disadvantages to an employee test. First, it could mean that otherwise quite large businesses that are staffed entirely using agency workers would count as micro-businesses because those agency workers were not on the payroll. There are also problems with sophisticated businesses that only have a few employees because they are set up as special purpose vehicles or project companies in complex structures. We discuss whether it is possible to apply a sophistication filter to these businesses later in Part 8.
- 7.30 Second, if the question about the number of employees were tied to data given in the most recent annual submission end of year return to HMRC, then there could be as much of a problem with time delay as there is with turnover.
- 7.31 Third, in the same way as a turnover test may be biased in favour of those companies that provide services, an employee test may have the opposite bias in favour of businesses that manufacture items or produce goods. Such businesses are likely to have higher turnover figures than a micro-business that sells services.
- 7.32 Finally, there would also be problems establishing the number of employees in a recent start-up company. As with a turnover test, the business would need to give a projected number of employees. This problem may be less acute for an employee test than it would be for a turnover test because it is easier for a new start-up company to predict the number of employees that it will have than the amount of turnover it will have.
- 7.33 **Is an employee test sufficient to define a micro-business?**
- 7.34 **Should a micro-business be defined as a business with fewer than 10 employees?**
- 7.35 **Should the number of employees be assessed:**
- (1) **from the most recent annual return to HM Revenue & Customs available at the time of the entering into the contract;**
 - (2) **from a business' own assessment of its payroll records for the 12 months immediately preceding the application for insurance; or,**
 - (3) **in some other way ? (If so, please specify.)**
- 7.36 **Should the number of employees in the case of a new start-up business be assessed from projected numbers of employees?**

¹⁵ See BERR statistics, Table 1, UK Private Sector, <http://stats.berr.gov.uk/ed/sme/>.

OPTION 3 - FINANCIAL OMBUDSMAN SERVICE JURISDICTION LIMIT

- 7.37 The final option is to tie the definition of micro-business to the Financial Ombudsman Service jurisdiction limit. Currently a business is entitled to have a case against an insurer heard by the FOS when that business has a turnover of less than £1 million at the time of the claim. Tying the definition of a micro-business to this definition was one of the proposals made in the section on turnover, above at paragraph 7.18, although we think that this turnover should be assessed at the time that the parties enter into the contract and not at the time of the claim.¹⁶
- 7.38 However, a problem with tying the definition of a micro-business to the FOS jurisdiction limit is that the FOS limit may be about to change. The Financial Services Authority has been consulting on this recently in a document entitled "Implementation of the Payment Services Directive".¹⁷ One section of that document proposes that the FOS's jurisdiction be changed, not only in the context of payment services¹⁸ but for all firms authorised and regulated by the FSA, which would include insurance.
- 7.39 The proposal is that the FOS will be able to hear complaints against insurance firms from businesses that have fewer than 10 employees and a turnover of less than €2 million. This will be assessed at the time of the claim.
- 7.40 We have several concerns about using this definition, some of which have been set out in earlier paragraphs. We think that a two-limb test may be too complex for policyholders and insurers alike, necessitating more work and increased costs. There is also more risk that errors will be made. Another disadvantage of this test is the fact that it will be expressed in euros. The exchange rate is currently unstable and this will be a further difficulty for insurers and policyholders. Finally, we still think that the size of a business should be assessed at the time it enters into (or renews) the contract and not at the time of the claim. The advantage, however, of adopting the FOS jurisdiction limit is that it would bring the law and the FOS jurisdiction more closely into line. We should be grateful for consultees' views.
- 7.41 **In theory, should the definition of micro-business be the same as the definition of a business that can take a claim to the Financial Ombudsman Service?**

¹⁶ This is because, when a business refers a claim to the FOS it is possible that even a large business' turnover will be reduced to less than £1 million by whatever has caused it to make the insurance claim in the first place. Also, both insurers and businesses need to know at the time they enter into the contract what regime of law they are governed by. For example, if a business is a micro-business, an insurer will need to apply the consumer law and will need to ask questions; it cannot rely on a duty to volunteer information. In order for pre-contractual information to be collected properly the parties cannot wait until a claim is made to decide how big the business is and which regime applies to it.

¹⁷ Financial Services Authority, Implementation of the Payment Services Directive – changes to the FSA Handbook, 08/14** (August 2008), para 2.8.

¹⁸ Payment services, broadly speaking, are services under which cash is placed in or withdrawn from a payment account. This includes transfer services such as direct debits, standing orders and money remittance services.

- 7.42 **In practice, however, should a micro-business be defined as a business that (at the time it enters into the contract of insurance) has fewer than 10 employees and a turnover of less than €2 million?**

EXCLUDED OPTION: THE BERR AND EUROPEAN COMMISSION DEFINITION

- 7.43 Our final option for defining a micro-business is to take the definition of a micro-business used by BERR and the European Commission. They described micro-businesses as businesses that have

- (1) between zero and nine employees; and
- (2) either
 - (a) annual turnover of less than €2 million; or
 - (b) assets of less than €2 million.

- 7.44 The advantage of this option is that the test is well known by industry. It is a broader and therefore more sophisticated test than the turnover and employee test.

- 7.45 We do not believe, however, that this test is better than the tests above. First, it does not solve the problems with using turnover figures and employee numbers as listed above. It will not, for example, solve the time-lag problems, the exchange rate problem or the problem with finding figures for recent start-ups. Instead, by forcing policyholders and insurers to deal with three separate figures, it increases the time that needs to be spent asking and answering questions and increases the likelihood that one or more of the answers will be incorrect, leading to dispute. It also adds a new problem, that of establishing an assets figure. Micro-businesses that are structured as companies will find it relatively easy to establish an assets figure. However, micro partnerships and sole traders may find it difficult to do so. It is hard for these entities to separate assets that relate to the business activity from personal assets. Given that so many businesses with less than 10 employees are structured as sole traders or partnerships¹⁹ we are concerned that this part of the test could be onerous for businesses and insurers.

- 7.46 We therefore do not propose to use the BERR and European Commission definition of a micro-business.

¹⁹ See para 2.8 above.

PART 8

THE PROBLEM OF SOPHISTICATED MICRO-BUSINESSES

INTRODUCTION

- 8.1 Whichever definition we choose for a micro-business, we need to avoid allowing highly specialised and sophisticated micro-businesses into the consumer regime. We see a particular problem with entities like special purpose vehicles (SPVs) or project companies which may have low (if any) turnover or few (if any) employees but yet are highly sophisticated parts of larger business structures and can hold assets or do business worth great amounts. It would be wrong for these types of businesses to be given protection under the consumer regime. We need to exclude them from our definition of micro-business. We can see three potential ways of doing this.

ASSOCIATED BUSINESSES

- 8.2 The first and most usual method would be to draft a wide definition of associated business to cover micro-businesses that were sophisticated because they are part of a larger structure. The association can be, for example, through voting rights or shareholding or powers conferred by the articles of association. Businesses would then have to include the turnover or employees from associated businesses when applying for insurance and this would ensure that the business no longer fell within the definition of micro-business.
- 8.3 A particular problem, however, arises with businesses set up as “orphan” companies. They are called orphan companies because their shares are often settled on charitable trusts and an administration company provides the directors. This ensures that there is no connection between the orphan and the sponsor; and, for many business structures, it is vital that there is no connection. An SPV in a securitisation, for example, would typically be legally separate from any of the other participants in the securitisation. It will have no employees and is used solely to isolate the business carried out by the SPV from other entities to minimise the risk to those other entities or for accounting purposes.¹ Such companies would fail many of the traditional tests for establishing an association between companies because, by design, one does not control the other as its owner or majority shareholder.

¹ See PLC July 2006, *Securitisation, An Overview* by Marin Bartlam of Orrick Herrington & Sutcliffe for further details.

- 8.4 In order to exclude these orphan companies from the definition of micro-business we recommended in the draft Bill on Unfair Terms in Contracts² that the definition of associated person should include those who have de facto ability to dictate how the business is run. The definition in the draft Bill applies to bodies corporate, unincorporated associations or partnerships and control is defined as securing that a party's affairs are conducted according to another party's wishes, directions or instructions.
- 8.5 The definition of Associated Person from the draft Bill on Unfair Terms is at Appendix A, together with other commonly used definitions.
- 8.6 Despite good definitions of Associated Persons, however, some orphan companies will never define themselves as being part of a larger group. They will not do so because they have been set up carefully to be independent. For example, they often hold independent board meetings. There would be huge tax consequences for the company if it were to admit control by another. Therefore, in addition to the basic associated business filter, there must be additional methods of eliminating sophisticated businesses from the micro-business regime. These are discussed below.

INSURANCE PREMIUM SPEND

- 8.7 The first additional filter is the amount a business spends on its insurance premium. If a business spent more than a set amount on its insurance premium then we propose that it would automatically fall within the business regime and not within the consumer regime. The research carried out by CRA indicated that a business with a turnover of less than £500,000 spent on average between 1.2% and 1.3% of that turnover on buying insurance.³ This would mean that its annual insurance would cost between £6,000 and £6,500. However, this is only the average cost of a policy for all businesses that have a turnover from between £1 to £499,999. It does not take into account the different sizes and types of business. We therefore think that, if premium spend is to provide a proper sophistication filter rather than being part of the initial test for a micro-business, the level should be set at a higher level. This would also avoid penalising those who buy combined commercial insurance rather than several separate policies. We believe therefore that a suitable level for a sophistication filter could be a premium level of £15,000 per policy.⁴
- 8.8 Ensuring that those businesses that spent over £15,000 on an insurance policy would fall within the business regime, regardless of the business size, would mean that parties to these expensive insurance contracts would have more freedom to agree terms. We do not believe that any entity would spend such an amount on insurance without taking advice from a broker, and would certainly not be buying a standard contract over the internet. This means that they are unlikely to be similar to a consumer when buying insurance and therefore it is right that they should be excluded from the consumer regime.

² Unfair Terms in Contracts (2005) Law Com No 292; Scot Law Com No 199.

³ See para 2.12, above.

⁴ Provision will need to be made for this figure to be updated periodically.

HIGH ASSET AND TURNOVER FILTERS

Application to employee definition of micro-business

- 8.9 A particular problem, if we chose an employee-only definition of micro-business, is that the majority of sophisticated project companies and SPVs will be defined as micro-businesses as they have few, if any, people working for them. Some should be excluded by the associated business test described above that requires businesses to include employees in associated companies but many may not be.
- 8.10 An alternative way to exclude sophisticated businesses from our employee-only definition of micro-business is to introduce an extra, very high asset and turnover filter.
- 8.11 The drawbacks of establishing assets for many micro-businesses has been discussed above,⁵ but, if the asset and turnover filter test were set at a high level then the vast majority of micro-businesses would not need to think about the question. It would simply catch those specialised companies that have few employees but carry out high value business or hold a very expensive asset. Examples are SPVs in a typical securitisation structure or SPVs that hold aircraft in a typical asset finance structure.⁶

Application to turnover definition of micro-business

- 8.12 If a turnover test is adopted to define a micro-business, then it also might be advisable to use an asset filter. The problem with using a turnover test alone is that some sophisticated micro-businesses will not have any turnover for periods of their life. These kinds of companies simply hold assets. A high asset filter would therefore prevent these companies from being defined as micro-businesses.

Conclusion

- 8.13 We would be interested in consultees' views on whether high asset and turnover filters are necessary or whether the associated business test would be sufficient. We would also be interested in consultees' views on the level of the tests and propose £10 million for both.

SOPHISTICATION FILTERS - CONCLUSION

- 8.14 We believe that the most straightforward solution to the problem of sophisticated micro-businesses would be to adopt a broad definition of control and associated companies. Then sophisticated micro-businesses would include the employees or turnover from other parts of the business structure when answering questions on size.

⁵ See para 7.45, above.

⁶ It is possible, however, that companies could be set up in asset finance schemes to hold much lower value equipment, such as photocopiers, and these companies would not necessarily be excluded by the filter test.

- 8.15 In addition, we believe that there needs to be a high value premium filter, which would allow more freedom of contract should a micro-business spend a very large amount on an insurance contract.
- 8.16 We ask for consultees' views on whether it is necessary to have, in addition, very high asset and turnover filters.
- 8.17 **Do consultees agree that the number of employees or turnover of a business should include those employed by or the turnover of any associated person?**
- 8.18 **Do consultees agree that we should use the test of an “associated person” set out in the Law Commissions’ draft Bill on Unfair Contract Terms? (given in Appendix A)?**
- 8.19 **Do consultees agree that this is enough to exclude sophisticated micro-businesses from the micro-business regime, or do they think that extra measures are necessary?**
- 8.20 **If extra measures are necessary, do consultees agree that a business that spends more than a certain amount on any one insurance premium should fall outside the definition of a micro-business for the purposes of buying that policy? If so, is £15,000 an appropriate level?**
- 8.21 **If extra measures are necessary, do consultees agree that a business that has assets worth more than £10 million or an annual turnover of more than £10 million should not be defined as a micro-business?**

PART 9

THE TEST IN PRACTICE

INTRODUCTION

- 9.1 This Part sets out some brief notes on the consequences of a business or an insurer making a mistake in its classification of the business.
- 9.2 When we refer to the consumer/micro-business regime below, we are referring to the consumer regime as described in Part 4 of this Paper and in the summary of responses to our Consultation Paper.¹ When reference is made below to the business regime, we mean the new regime for small, medium and large businesses as proposed in the Issues Paper which will be published after this Paper.
- 9.3 We have tried to suggest uncontroversial tests to avoid disputes in this area. If an employee test is adopted, for example, relatively few businesses sit on the dividing line between 8 and 10 employees meaning that it should be clear for the majority of insurers and policyholders which law applies to them.

PROCESS

- 9.4 If an insurer sells a micro-business a policy which does not reflect the consumer/micro-business regime, the insurer will not be able to rely on terms that give the micro-business fewer rights than it would have had under the consumer/micro-business regime. The insurer may therefore wish to ask questions about size and turnover to establish from the outset the rights of both parties. It cannot, under the consumer/micro-business regime, rely on the micro-business to volunteer the fact that it is a micro-business.
- 9.5 There is a more difficult question relating to larger businesses. For most policies, a business would know that information about its size would be material. However, it is unlikely that it will volunteer the fact that it is not a micro-business and instead is a larger business according to any new insurance contracts Act. Most prudent insurers should ask questions to establish the size of the business as this will be relevant for underwriting purposes. We understand this is common practice for direct sales. However, the possibility remains that a business could fail to volunteer information about its classification and an insurer could fail to ask for it. In these circumstances, the insurer, having misunderstood the size of a business could sell a larger business a policy that, instead of reflecting the business regime, reflects the consumer/micro-business regime. Here, we do not think that it is fair for the insurer to be able to rely on the business' duty to volunteer that it is in fact a larger business. It should abide by the terms of the contract it has sold, even when that contract gives the business more rights than it would otherwise have had under the business regime.

¹ Reforming Insurance Contract Law: A Summary of Responses to Consultation on Consumer Issues (May 2008).

- 9.6 **If an insurer does not ask sufficient questions and sells a micro-business a policy which gives that business fewer rights than it would have had under the consumer/micro-business regime, we provisionally propose that the insurer cannot rely on those terms and must apply the consumer/micro-business regime instead.**
- 9.7 **If a business fails to volunteer whether it is a micro-business or a larger business and the insurer does not ask sufficient questions to find out, we provisionally propose that the insurer cannot rely on the business' duty to volunteer this information. Instead, the insurer should abide by the terms of the contract it has sold, even when that contract gives the business more rights than it would otherwise have had under the business regime.**

MISREPRESENTATIONS ABOUT SIZE

A micro-business makes a mistake in answering a question about its size and portrays itself as a small, medium or large business

- 9.8 If a micro-business makes a mistake in answering a question about its size and portrays itself as a small, medium or large business, that answer should be treated in the same way as all misrepresentations are treated under the consumer regime, as described in Part 4. Therefore, if it acted deliberately or recklessly, the insurer can avoid the contract. If it acted reasonably, then the insurer would have to deal with the micro-business according to the consumer regime.
- 9.9 If the micro-business behaved negligently, then, under the normal rules the insurer is entitled to apply what it would have done had it known the truth. There are two possibilities:
- (1) The first is that the micro-business would not have been sold a policy on those terms. In these circumstances, we think that a normal proportionate remedy should apply. Where, for example, the premium would have been higher, the claim should be reduced proportionately; where exclusions or limitations or other terms would have been applied, then the policy would have those terms implied into it.
 - (2) The second and more difficult scenario is that the micro-business would not have been sold a policy at all because, for example, that insurer did not deal with micro-businesses. The normal proportionate remedy in these circumstances would mean that the micro-business would be left without a policy for a negligent misrepresentation. This would be a harsh remedy in circumstances where the size of the business may have had no bearing on the nature of the risk itself.
- 9.10 We therefore ask consultees whether in the second scenario the law should specify that the parties must abide by the terms of the policy that was sold? This only becomes an issue where the insurer has a policy of not dealing with micro-businesses at all, and we are not sure how likely insurers will be to have fixed policies of this sort. We would therefore be grateful for comments from consultees on this scenario.

- 9.11 **We provisionally propose that if a micro-business makes a mistake in answering a question about its size and portrays itself as a small, medium or large business, that answer should be treated in the same way as all misrepresentations are treated under the consumer regime.**
- 9.12 **Is there a need to specify the consequences if a micro-business makes a negligent misrepresentation about its size and the insurer would not have sold it a policy at all had it known the truth. In these circumstances only, should the statute specify that both parties must abide by the terms of the policy?**

A small, medium or large business makes a mistake in answering a question about its size and portrays itself as a micro-business.

- 9.13 If a small, medium or large business makes a mistake in answering a question about its size and portrays itself as a micro-business, that answer should be treated in the same way as all misrepresentations and non-disclosures are treated under the business regime.
- 9.14 We have not yet finalised our proposals for misrepresentation and non-disclosure for the business regime but it is clear that any deliberate or reckless behaviour should entitle the insurer to avoid the contract. We are considering applying a proportionate remedy to other types of misrepresentation and non-disclosure (both reasonable and negligent). If we do so then the insurer will be entitled to do what it would have been entitled to do had it known the truth, including applying other terms to the contract (including the obligation to volunteer other relevant facts).
- 9.15 The insurer may also argue, as described above, that it would not have sold any contract to the business at all. This would allow the insurer to avoid the policy altogether. Again we ask whether this is a fair result. An alternative would be to specify that, if a larger business made a negligent or reasonable misrepresentation that it was a micro-business, the insurance should be valid, but should be subject to the normal business regime in all other respects. We wonder, however, whether this would be regarded as adding unnecessary complexity.
- 9.16 **We provisionally propose that if a small, medium or large business makes a mistake in answering a question about its size and portrays itself as a micro-business, that answer should be treated in the same way as all misrepresentations and non-disclosures are treated under the business regime.**
- 9.17 **Is there a need to specify the consequences if a larger business makes a non deliberate or reckless misrepresentation that it is a micro-business and the insurer would not have sold it a policy at all had it known the truth. In these circumstances should the statute specify that the insurance is valid, but subject to the normal business regime?**

PART 10

PROPOSALS AND QUESTIONS

INTRODUCTION

- 10.1 In this part we have put together all the proposals and questions we have asked in this Issues Paper. We have added the paragraph reference to the place in the text where each question or tentative proposal is discussed. It will often be necessary to look back at the paragraph reference to set the question or proposal in context.

MICRO-BUSINESSES AND PRE-CONTRACTUAL INFORMATION

- 10.2 We provisionally propose that micro-businesses should be treated as consumers for the purposes of pre-contractual information (4.12).
- 10.3 We provisionally propose that small businesses should be treated as businesses for the purposes of pre-contractual information (4.13).

MICRO-BUSINESSES, UNFAIR TERMS AND WARRANTIES

- 10.4 Should the provisions of the Unfair Terms in Consumer Contracts Regulations 1999 be extended to micro-businesses for the purposes of insurance contracts (5.39)?
- 10.5 We ask consultees whether, in addition to the UTCCR, a causal connection test is necessary for terms described as warranties which apply to future conduct in micro-business insurance contracts (6.24).
- 10.6 The causal connection test is the one as set out in the Consultation Paper,¹ namely that a 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 (6.25).

BASIC DEFINITION OF A MICRO-BUSINESS

- 10.7 We have asked consultees to tell us their preferred way of defining a micro-business. Three options are set out below.

Option 1 - Turnover test?

- 10.8 Do consultees believe that a turnover test is sufficient to define a micro-business (7.16)?
- 10.9 If so, do they agree that turnover should be assessed from the most recent accounts available at the time of entering into the contract (or from projected turnover in the case of a new start-up business)(7.17)?
- 10.10 What level should the turnover definition be set at? Should it be:

¹ Insurance Contract Law: Misrepresentation, Non-disclosure and Breach of Warranty by the Insured (2007) Law Commission Consultation Paper 182; Scottish Law Commission Discussion Paper 134. <http://www.lawcom.gov.uk/docs/cp182.pdf>.

- (1) tied to the level of the BERR turnover arm of its definition of a micro-business (currently €2 million); or,
- (2) tied to the level of FOS jurisdiction (currently £1 million) assessed at the time the contract was entered into;
- (3) set at an independent level which will need to be amended from time to time? If so, what should the level be (7.18)?

Option 2 - Employee test?

- 10.11 Is an employee test sufficient to define a micro-business (7.33)?
- 10.12 Should a micro-business be defined as a business with fewer than 10 employees (7.34)?
- 10.13 Should the number of employees be assessed:
- (1) from the most recent annual return to HM Revenue & Customs available at the time of the entering into the contract;
 - (2) from a business' own assessment of its payroll records for the 12 months immediately preceding the application for insurance; or,
 - (3) in some other way ? (If so, please specify.(7.35))
- 10.14 Should the number of employees in the case of a new start-up business be assessed from projected numbers of employees (7.36)?

Option 3 - Financial Ombudsman Service Test?

- 10.15 In theory, should the definition of micro-business be the same as the definition of a business that can take a claim to the Financial Ombudsman Service (7.41)?
- 10.16 In practice, however, should a micro-business be defined as a business that (at the time it enters into the contract of insurance) has fewer than 10 employees and a turnover of less than €2 million (7.42)?

HOW SHOULD WE EXCLUDE SOPHISTICATED BUSINESSES FROM THE DEFINITION?

- 10.17 Three "sophistication filters" are proposed to ensure that small but sophisticated micro-businesses will be excluded from the definition. We should be grateful for consultees' views on these.
- 10.18 Do consultees agree that the number of employees or turnover of a business should include those employed by or the turnover of any associated person (8.17)?
- 10.19 Do consultees agree that we should use the test of an "associated person" set out in the Law Commissions' draft Bill on Unfair Contract Terms (given in Appendix A) (8.18)?

- 10.20 Do consultees agree that this is enough to exclude sophisticated micro-businesses from the micro-business regime, or do they think that extra measures are necessary (8.19)?
- 10.21 If extra measures are necessary, do consultees agree that a business that spends more than a certain amount on any one insurance premium should fall outside the definition of a micro-business for the purposes of buying that policy? If so, is £15,000 an appropriate level (8.20)?
- 10.22 If extra measures are necessary, do consultees agree that a business that has assets worth more than £10 million or an annual turnover of more than £10 million should not be defined as a micro-business (8.21)?

CONSEQUENCES OF FAILURE TO ASK SUFFICIENT QUESTIONS OR TO PROVIDE ACCURATE INFORMATION ABOUT SIZE

Insurers who ask insufficient questions about the size of a business

- 10.23 If an insurer does not ask sufficient questions and sells a micro-business a policy which gives that business fewer rights than it would have had under the consumer/micro-business regime, we provisionally propose that the insurer cannot rely on those terms and must apply the consumer/micro-business regime instead (9.6).
- 10.24 If a business fails to volunteer whether it is a micro-business or a larger business and the insurer does not ask sufficient questions to find out, we provisionally propose that the insurer cannot rely on the business' duty to volunteer this information. Instead, the insurer should abide by the terms of the contract it has sold, even when that contract gives the business more rights than it would otherwise have had under the business regime (9.7).

Misrepresentations and non-disclosures by policyholders about the size of their business

Misrepresentations from micro-businesses

- 10.25 We provisionally propose that if a micro-business makes a mistake in answering a question about its size and portrays itself as a small, medium or large business, that answer should be treated in the same way as all misrepresentations are treated under the consumer regime (9.11).
- 10.26 Is there a need to specify the consequences if a micro-business makes a negligent misrepresentation about its size and the insurer would not have sold it a policy at all had it known the truth. In these circumstances only, should the statute specify that both parties must abide by the terms of the policy (9.12)?

Misrepresentations from small, medium or large businesses

- 10.27 We provisionally propose that if a small, medium or large business makes a mistake in answering a question about its size and portrays itself as a micro-business, that answer should be treated in the same way as all misrepresentations and non-disclosures are treated under the business regime (9.16).

10.28 Is there a need to specify the consequences if a larger business makes a non deliberate or reckless misrepresentation that it is a micro-business and the insurer would not have sold it a policy at all had it known the truth. In these circumstances should the statute specify that the insurance is valid, but subject to the normal business regime (9.17)?

APPENDIX A

DEFINITIONS OF ASSOCIATED BUSINESSES

- A.1 This Appendix sets out the definition of associated persons used in our 2005 draft Bill on unfair contract terms. We then discuss how it compares with other commonly used definitions.

DEFINITION IN THE UNFAIR CONTRACT TERMS BILL

- A.2 In the Law Commissions' draft Bill for the Unfair Contract Terms project,¹ this definition of associated person was used. It applies to bodies corporate, unincorporated associations or partnerships and control is defined as securing that a party's affairs are conducted according to another party's wishes, directions or instructions.

- (1) For the purposes of this Act, two persons are associated if-
 - (a) one controls the other, or
 - (b) both are controlled by the same person.
- (2) A person ("A") controls a body corporate ("B") if A can secure that B's affairs are conducted according to A's wishes, directions or instructions.
- (3) The reference in subsection (2) to wishes, directions or instructions does not include advice given in a professional capacity.
- (4) Subsection (2) applies, with any necessary modifications, in relation to an unincorporated association (other than a partnership) as it applies in relation to a body corporate.
- (5) A person controls a partnership if he has the right to a share of more than half the assets or income of the partnership.
- (6) For the purposes of this section, one person does not control another just because he grants that other person a right to supply goods or services. [This subsection is to prevent the definition of control applying in relation to franchises.]

OTHER DEFINITIONS

Definition of affiliate in a commercial contract

- A.3 Below we set out a definition of "affiliate" used in a commercial contract. We understand that standard terms of this type are common. Although the drafting style is different, we think that the substance of this definition is similar to the one used in the Unfair Contract Terms Bill. Again, the definition covers all types of business entity. It is based on "control", which is defined broadly to include the ability to direct the management or policies of an entity. This may be done by organisational means, by contract, "or otherwise".

Affiliate - in relation to any entity, any other entity that, directly or indirectly controls, is under common control with, or is controlled by, that entity. For the purpose of this definition, "control" (including, with its correlative meanings, the terms "controlled by" and "under common control with"), shall mean the control, directly or indirectly, or the ability to direct or cause the direction of the management and policies of such entity, whether through the ownership of voting shares of such entity, the power to control the composition of the board of directors or other governing body of such entity, or by contract or otherwise.

Section 839/940 of the Income and Corporation Taxes Act 1988

- A.4 Finally, we looked at the definitions of control found in sections 839 and 840 of the Income and Corporation Taxes Act 1988. However, we feel that this is too complicated for the purposes of buying insurance cover as it would involve the insurer having to ask questions about family relationships and family business interests. We therefore do not propose that this definition is appropriate for identifying connected businesses for the purposes of buying insurance.

¹ Unfair Terms in Contracts (2005) Law Com No 292; Scot Law Com No 199, Draft Bill, Clause 28.