PART 1: INTRODUCTION

THE LAW COMMISSIONS AND INSURANCE CONTRACT LAW REFORM: AN UPDATE

1.1 Since 2006, the Law Commission of England and Wales and the Scottish Law Commission have been engaged in a joint project to reform the law of insurance contracts. The work has shown that the statutory provisions governing the law are in many ways outdated, uncommercial and out of step with the realities of 21st century business and insurance practices.

1.2 We are working on a draft Bill to cover the following:

(1) disclosure and misrepresentation in non-consumer insurance contracts (fair presentation);

(2) the law of insurance warranties;

(3) damages for late payment of claims; and

(4) insurers' remedies for fraudulent claims.

1.3 On 28 January 2014, we launched a limited consultation on draft clauses covering (1), (3) and (4) above, to which we received 38 responses.

FURTHER DRAFT CLAUSES

1.4 We are now able to share the remaining draft clauses addressing:

(1) insurance warranties;

(2) insurers' remedies for fraudulent claims by members of group insurance policies; and

(3) contracting out of the default rules. We are recommending mandatory regimes for consumer insurance, but only default provisions for non-consumer insurance. Commercial parties should be free to contract out of the reforms and substitute their own agreed regimes.

1.5 We welcome comments on these further draft clauses to commercialandcommon@lawcommission.gsi.gov.uk by Friday 21 March 2014.

1.6 The draft clauses are intended to reflect the proposals set out in our consultation papers, and this limited consultation is designed to test the success of the drafting in implementing these proposals, rather than to test the underlying policy. In some instances, we have refined our thinking in response to consultation responses and as a result of questions about the consequences of the proposals which have been uncovered as the drafting has progressed.

1.7 We hope to publish a final draft Bill and report by summer 2014.

PART 2: WARRANTIES

BACKGROUND AND POLICY

2.1 In general contract law, "warranties" are relatively minor contractual terms, the breach of which gives rise to damages. By contrast, compliance with an insurance warranty is of paramount importance. It is essentially a promise made by the policyholder to the insurer which, if broken, will have harsh consequences for the policyholder.

2.2 The general principles of insurance warranty law are founded on the rulings of Lord Mansfield, made in the late eighteenth century. The classic case is that of *De Hahn v Hartley*.[1] There, an insurance policy contained a term to the effect that a ship would leave Liverpool (for the West Indies) with "50 hands or upwards". The ship left Liverpool with only 46 hands, but picked up another six before it had left the relatively safe waters around Britain and before any loss was suffered. The ship was eventually captured and lost off the coast of Africa. The insurer refused to pay the claim on the basis that the term had not been strictly complied with. The court agreed: warranties had to be complied with "literally", and the insurer would be discharged from liability where they were not. It was immaterial that the breach of warranty had been remedied within a few hours and before any loss occurred.

2.3 These principles and attitudes were codified in the Marine Insurance Act 1906 (the 1906 Act). Section 33(3) states that a warranty "must be exactly complied with, whether material to the risk or not". If it is not exactly complied with then "the insurer is discharged from liability from the date of the breach of warranty". Section 34(2) confirms that once a warranty is breached, the policyholder "cannot avail himself of the defence that the breach has been remedied, and the warranty complied with, before loss".

2.4 The 1906 Act's provisions apply to marine insurance, but the common law has evolved in parallel and the same rules apply to all insurance contracts.[2]

2.5 In our June 2012 consultation paper (Consultation Paper 3)[3] we identified four key problems with the current law on insurance warranties:

(1) An insurer may refuse a claim for a trivial mistake which has no bearing on the risk.

(2) The insured cannot use the defence that the breach has been remedied.

[1] (1786) 1 TR 343.

[2] See generally *Pan Atlantic Ins Co Ltd v Pine Top Ins Co Ltd* [1995] 1 AC 501.

[3] Law Commission and Scottish Law Commission, LCCP 204/SLCDP 155: *Insurance Contract Law: The Business Insured's Duty of Disclosure and the Law of Warranties* (2012), para 14.1. Available at: http://lawcommission.justice.gov.uk/docs/cp204_ICL_business-disclosure.pdf and http://www.scotlawcom.gov.uk/law-reform-projects/joint-projects/insurance-law.

(3) The breach of warranty discharges the insurer from all liability, not just liability for the type of loss in question.

(4) Something that appears to be an innocuous statement can be converted into a full warranty using obscure words that are widely misunderstood. The prime example is "basis of the contract" clauses, which state that all statements by the insured form the "basis of the contract".

2.6 For many years, the courts have attempted to moderate the harshness of the law with creative reasoning. This approach has allowed the courts to do justice in some individual cases. Insurance market participants have said that this discourages insurers from taking purely technical points, or attempting to use warranties in a wholly unreasonable way. While this has its advantages, it also introduces complexity and uncertainty into the law.

2.7 The vast majority of consultees from all sides of the market agreed that there is a need to reform the law of warranties. The comments of one consultee (whose response was given in confidence) reflected widely held opinions:

> The current law in relation to warranties brings English law into disrepute and puts the English market at a competitive disadvantage against other jurisdictions in which a more balanced approach to the effect of such terms has been adopted. The draconian nature of a warranty under English law leaves insureds too often at the mercy of the goodwill of insurers in the event of breach.

Summary of recommendations

2.8 We made three main proposals, which received strong support from consultees:

(1) "Basis of the contract" clauses should be prohibited. These clauses convert even minor representations by an insured during placement into warranties, and absolve the insurer from liability if they are or become untrue. Unlike a failure to disclose information or a misrepresentation, the insurer is not required to show that warranted matters are material or induced it to enter into the contract.

(2) Warranties should become "suspensive conditions", meaning that an insurer would not be liable for losses under the policy while the insured is in breach of a warranty, but the insurer's liability could be restored if the breach of warranty is remedied.

(3) Where a term is designed to reduce the risk of a particular type of loss, or the risk of loss at a particular time or in a particular place then, if the insured is in breach of that term, the insurer should only be able to refuse claims for losses falling within that category of risk. This proposal is not confined to traditional warranties, and would apply to any contract term designed to reduce particular risks.

BASIS OF THE CONTRACT CLAUSES

Clause 8: Warranties and representations

2.9 This clause in the draft Bill targets basis of the contract clauses in non-consumer contracts. It mirrors section 6 of the Consumer Insurance (Disclosure and Representations) Act 2012 which abolished such clauses in the consumer context.

2.10 Abolishing basis of the contract clauses was a popular proposal. Most consultees agreed that it should not be possible for an insurer to use a contract term to convert the answers in a proposal form into warranties. The Law Society of Scotland said:

> it is clauses such as these that give rise to the impression that insurers can avoid liability for an insured risk at their discretion.

2.11 The Lloyd's Market Association (LMA) also gave their support:

> Blanket "basis of the contract clauses" in commercial contracts, i.e. that all representations in the disclosure material be converted to warranties and incorporated into the contract of insurance, should be of no effect.

2.12 It will no longer be possible to turn an individual answer or statement into a warranty by using this type of wording.

2.13 The proposals are not intended to prevent insurers from including specific terms within a policy, or otherwise making express agreements with the policyholder, covering similar subjects to those previously discussed or asserted between the parties. However, if an insurer wants a warranty or definition of risk in respect of any particular matter, this must be expressly agreed between the parties.

WARRANTIES TO SUSPEND RATHER THAN DISCHARGE LIABILITY

2.14 There was very strong support from consultees for the proposals that the insurer's liability (1) should be suspended rather than terminated at the point of breach, and (2) should be restored if and when the breach was remedied. The LMA was "sympathetic" to this proposal, and the Association of British Insurers agreed:

> Some warranties should be treated as suspensive conditions so that a breach of such a warranty would suspend the insurer's liability for the duration of the breach rather than discharge it.

2.15 Professor Howard Bennett analysed the problem theoretically in terms of attachment of risk, and concluded that "there is no logical reason why the discharge of liability triggered by a breach of warranty need be permanent; there is no logical reason why it should be impossible to cure a breach of warranty".

Clause 9: A new remedy for breach of warranty

Breach of warranty not to discharge the insurer's liability

2.16 Clause 9 removes the insurer's existing remedy for breach of warranty:

(1) Clause 9(1) removes any rule of (common) law to the effect that breach of warranty (whether express or implied) discharges the insurer's liability; and

(2) Clause 9(7) removes the corresponding statutory provision by deleting the second sentence of section 33(3) of the 1906 Act.

New remedy for breach of warranty: suspension of liability

2.17 Clause 9(2) provides that an insurer has no liability for a loss occurring, or attributable to something happening, after a warranty has been breached but before the breach has been remedied (if, indeed, it can be remedied).

2.18 This provision applies to both express and implied warranties and therefore applies to the implied marine warranties in sections 39, 40 and 41 of the 1906 Act. This is necessary because the existing remedy for breach of those warranties (discharge of liability by virtue of section 33(3)) is removed, as discussed above.

2.19 The "attributable to something happening" wording caters for the situation in which loss arises as a result of an incident which occurred after a breach, but is not actually suffered until after the breach has been "remedied". In a presentation of 25 April 2013, Professor Baris Soyer gave the example of a vessel which, in breach of warranty, sails into a war zone. She suffers some damage while in the area but is lost only after she has sailed out of that zone. The breach has been "remedied" but the policyholder should still not be able to recover because the loss is attributable to the event during the period of breach.

2.20 Clause 9(4)(a) confirms that the insurer is liable for losses occurring before the breach of warranty. This is consistent with the position under the current law.

2.21 Clause 9(4)(b) provides that the insurer is also liable for losses occurring after the breach has been remedied. It explicitly acknowledges that some warranties cannot be remedied, as this was an important issue for many consultees. Section 34(2) of the 1906 Act, which provides that remedying a breach is not a defence, is deleted by clause 9(7)(b) of our draft Bill.

REMEDYING A BREACH OF WARRANTY

2.22 Whether, and when, a breach of warranty has been remedied are important questions. If a policyholder warrants that an alarm system will be inspected every six months and misses a six-monthly inspection, the breach is not technically "remedied" if the inspection takes place at month seven. However, our view is that liability should only be suspended during that one month period for which there had been no inspection. We think that the proper approach turns on the conception of warranties as risk control measures. A breach of warranty can be said to have been properly or functionally remedied when the risk is restored to the state it would have been in had the breach not taken place.

2.23 This matter is addressed in clauses 9(5) and 9(6). These provisions apply to warranties which provide that, at or by a particular time, something must have been done, or not done, or some condition must be fulfilled, as described in 9(5). This is intended to catch warranties which include some sort of deadline. Clause 9(6) provides that, where such a warranty is breached (ie a deadline is missed), the breach is remedied if at a later point the risk to which the warranty relates becomes essentially the same as that originally contemplated by the parties.

2.24 Under these provisions, we think that *De Hahn* would be decided differently. Once the ship had left Liverpool with fewer than 50 hands, as a matter of logic the "breach" could not be truly remedied: the ship could not go back in time and leave again, this time with sufficient men aboard. However, when the ship picked up another six men in Anglesey, the breach had, arguably, been functionally remedied. During the six hours when the ship was shorthanded, the risk was outside the scope of the policy, and the insurer's liability should have been suspended (or, indeed, the insurer would not yet have come on risk). When the additional hands came aboard, the risk was restored to the state in which the insurer was prepared to accept it, and the insurer ought to have been liable for losses suffered after that point.

Excused non-compliance and waiver: no change to current law

2.25 Sections 34(1) and (3) of the 1906 Act provide instances where the breach of a warranty does not affect the insurer's liability for loss. Our draft bill repeals section 34[4] and re-enacts these exceptions for all insurances (rather than only marine insurance).

2.26 Clause 9(3) therefore provides that 9(2) does not apply (that is, the insured's liability is not suspended for breach of warranty) if:

(a) because of a change of circumstances, the warranty ceases to be applicable;

(b) compliance with the warranty is rendered unlawful; or

(c) the insurer waives the breach of warranty.

TERMS TO REDUCE PARTICULAR RISKS

2.27 In Consultation paper 3[5] we proposed that, where a term is designed to reduce the risk of a particular type of loss, breach of that term should suspend cover only in respect of losses of that type. Similarly, we said that if a term is intended to reduce the risk of loss at a particular time or location, then breach of that term should only suspend cover in relation to such losses. If the breach is capable of remedy, full cover would be restored when fixed. There was very strong support for these proposals. Airmic said its members were:

> overwhelmingly in favour of the suggestion that in the event of a breach, the liability of the insurer should only be suspended in respect of that type of loss.

[4] Clause 9(7)(b).

[5] Paras 15.35 to 15.52.

2.28 To take basic examples, breach of a term requiring a policyholder to have certain fire safety systems in place should result in suspension of the insurer's liability in respect of fire-related risks. Breach of a condition that a vessel in port must retain a night watchman would mean suspension of the insurer's liability for losses occurring while the watchman should have been present. Importantly, a causal link between the breach and the ultimate loss is not required. The insurer would not be liable for any loss falling within the particular category with which the warranty or other condition is concerned.

Clause 10: Terms relevant to particular descriptions of loss

2.29 We were advised by consultees that it would be very difficult to show what a clause was "designed" to do, because many insurers use standard form contract documents. Therefore, the warranty or similar term is not included for a specific reason each time.

2.30 Clause 10(1) therefore refers to contractual terms which, if complied with, "would tend to reduce the risk" of loss of a particular kind, or loss at a particular location or time. We hope that this will enable an objective assessment of the "purpose" of the provision.

2.31 Clause 10(2) provides that, if a term falls within clause 10(1), then the insurer's liability is not excluded, limited or discharged in respect of other types of loss (that is, loss of a different kind, or loss at a different location or time).

2.32 The effect of the proposals would be that breach of the relevant term would suspend the insurer's liability under the whole contract, unless it is shown that the warranty (or other term) is narrower in scope. The question is whether, as a matter of objective construction, the term is relevant to reducing a particular risk.

2.33 Importantly, the term should not be considered in light of what has actually happened. That is, it is not relevant whether or not breach of the term actually contributed to the loss which has occurred. It is sufficient that the term is relevant to the particular kind, time or place of loss. If that is the case, the insurer is not liable for the actual loss.

2.34 We acknowledge that whether a term is designed to reduce a particular risk, and if so which risk, or whether it is designed to delimit the scope of the insurance contract more generally, may become the subject of litigation if the proposals are enacted. However, we consider that overall there will be an increase in certainty for both parties. Judicial treatment of warranties and similar provisions is already uncertain as courts strain to find ways to avoid the draconian consequences of breach. The suspension/remedy policy together with the "type of loss" proposals should channel litigants on both sides towards less speculative arguments and cause them to be less reliant on favourable exercise of the courts' discretion.

An illustration

2.35 The broad effect of this clause can be illustrated with an example:

> A private individual insures a small yacht. The policy includes three warranties:

- A "premium payment" warranty, requiring payment by 1 June;

- A "lock warranty" requiring the hatch to be secured by a special type of padlock; and

- A "pleasure use only" warranty, forbidding the yacht to be used for commercial gain.

The policyholder breaches all three warranties. They fail to pay until 15 June; they install the wrong type of padlock; and they use the yacht for paid fishing trips. On 1 July the policyholders are using the yacht to transport paying customers when it is damaged by a sudden storm.

2.36 The consequences of each breach would be as follows:

(1) Under the current law, breach of a premium payment warranty discharges the insurer from liability, which is not restored if the insurer later accepts payment. Under the proposals, however, we think that the payment on 15 June would remedy the breach and the insurer's liability would be restored. The insurer would not be permitted to reject the claim solely on this basis.

(2) Compliance with the lock warranty would tend to reduce the risk of a specific type of loss: loss caused by intruders. Under the proposals, it would not suspend the insurer's liability for other types of loss, such as loss in a storm. This would not be a good reason to refuse the claim. However, if there was a break-in, liability would be suspended even if the special padlock would not have prevented it.

(3) The pleasure use only warranty relates to the contract generally, and suspends the insurer's liability for all losses until such time as it is remedied. Clearly in this case it has not been remedied, and the insurer may reject the claim on this basis. It does not matter whether the breach caused the loss. In Consultation Paper 3,[6] we argued that this would also apply where the yacht is damaged while berthed overnight, applying the case of *Murray v Scottish Automobile*,[7] as this is ancillary to the forbidden activity.

6 Paras 15.18 and 15.19.

7 1929 SLT 114. In that case, a car was destroyed while parked overnight but had been used for hire purposes, in breach of warranty, on that day and the preceding days. The court held that its being parked overnight was ancillary to the main (commercial) purpose to which the car was being put, and therefore the insurer was not liable.

PART 3: INSURERS' REMEDIES FOR FRAUDULENT CLAIMS BY MEMBERS OF GROUP INSURANCE SCHEMES

BACKGROUND AND POLICY

3.1 Group schemes are an increasingly important form of insurance. Typically, such schemes are set up by employers for the benefit of their employees and concentrate on protection insurance: nearly 40% of life cover, for example, is provided through such schemes. Yet the legal principles which apply to such schemes are uncertain and under-developed.

3.2 Under a group scheme, the policyholder is typically the employer, who arranges the scheme directly with the insurer. The group members have no specific status. Indeed, insurers are often nervous of any attempt to define the status of group members. For some purposes (such as insurable interest) it is important that they are seen as beneficiaries, while for others (such as tax) there are advantages in writing a purely discretionary scheme, in which the member has no enforceable interest.

3.3 We discussed remedies for fraudulent claims by group members in our second consultation paper.[8] It is often the case that the people who receive the benefit under the group insurance policy are not parties to the contract, leaving insurers with limited remedies where the person entitled to benefit under the policy acts fraudulently when making a claim. Under the current law, the normal result is either that the insurer is left without any protection at all (on the ground that the fraudster was not the policyholder) or the entire policy fails for all employees (on the ground that fraud allows avoidance). Neither outcome is satisfactory.

3.4 We propose that where a fraudulent act is committed by one or more group members, the group member(s) concerned should be treated as if they are a party to the contract. The effect of this would be that the statutory remedies would apply: a group member who commits fraud to obtain a benefit under the group scheme would forfeit the entire benefit of the claim and, at the insurer's option, any subsequent benefit under the contract. For the avoidance of doubt, it is only the fraudulent member who would be affected; innocent group members would not be prejudiced.

DEFINITION OF GROUP INSURANCE: CONSUMER SCHEMES ONLY

3.5 Section 7 of the Consumer Insurance (Disclosure and Representations) Act 2012 (CIDRA) provides that the Act's provisions on disclosure and representations apply to a prospective group insurance member as if that group member was entering into the insurance contract directly with the insurer.

[8] Law Commission and Scottish Law Commission, LCCP 201/SLCDP 152: *Insurance Contract Law: Post Contract Duties and other Issues*, covering damages for late payment, insurers' remedies for fraudulent claims, insurable interest and policies and premiums in marine insurance (2011), paras 9.1 – 9.9. http://lawcommission.justice.gov.uk/docs/cp201_ICL_post_contract_duties.pdf.

3.6 The definition of group insurance, contained in clause 12(1) of our current draft, follows the CIDRA definition. The provision is drafted widely. It not only covers the typical employment schemes, but may also cover block building policies taken out by landlords for tenants, or buildings insurance taken out by freeholders for long leaseholders. It is possible for group insurance to cover only one member, where (for example) a freeholder takes out insurance for a single leaseholder.

3.7 To fall within the clause:

(1) A policyholder (A) must take out a policy which is of direct benefit to a third party (C). The policy must normally do more than simply cover A's liability towards C. It must also provide some additional cover for C (such as life insurance or contents insurance).

(2) C must not be a party to the contract.

(3) The cover would be a consumer insurance contract if C had taken it out directly. For example, life or household contents insurance would normally be consumer insurance.

(4) C must make a fraudulent claim. The fraudulent member is referred to as CF. If the policyholder, A, is involved in the fraud, clause 11[9] will apply as normal and the entire policy will be affected.

Group insurance in a non-consumer context?

3.8 We have not received any evidence to suggest that insurers require a remedy for fraud by a non-consumer member of this type of scheme. We understand that policies which are taken out by a single policyholder, such as a parent or holding company, for a number of named beneficiaries, are not treated as "group insurance" policies. Rather, they are regarded as bundles of individual insurance contracts.

3.9 We would be interested to hear any alternative views.

THE INSURER'S REMEDY FOR FRAUD BY A MEMBER OF A GROUP INSURANCE SCHEME

3.10 Where a group member (C) makes a fraudulent claim under a group insurance policy, clause 12(2) provides that the provisions of clause 11 apply as if the insurer and the fraudulent member (CF) had entered into a separate insurance contract between them, with CF as the policyholder.

3.11 Where a CF makes a fraudulent claim under a group insurance contract, the insurer therefore:

(1) has no liability to pay the fraudulent claim;

(2) has the option to terminate their liability to pay out in respect of losses suffered after the fraudulent act, *but only as regards CF*; and

[9] Clause 11 sets out the insurer's remedies for a fraudulent claim made by a policyholder. In the draft published on 28 January 2014, this was clause 10

(3) remains liable for legitimate losses suffered by CF *before* the fraudulent act.

3.12 These remedies were discussed more generally, in the context of a fraudulent claim made by a policyholder, in our notes published on 28 January 2014.[10]

Operation of the remedies against the fraudulent member only

3.13 Clause 12(2)(a) emphasises that the insurer's remedies are only exercisable against the fraudulent member, CF. That means it may not treat its entire liability under the contract as terminated, but only its liability to CF.

3.14 Clause 12(2)(b) confirms that the insurance cover provided to the other Cs (the non-fraudulent members of the group scheme) is not affected by CF's fraud.

Application of the remedy against the fraudulent member

Recovery of sums paid in respect of the fraudulent claim

3.15 The arrangements for payment of insurance monies under a group insurance contract differ. The insurer may either pay insurance monies to the policyholder, A (who would pass it on to the relevant group member) or may pay the group member directly. Clause 12(3)(a) therefore confirms that the insurer may reclaim sums paid in respect of the fraudulent claim from either A or CF, depending on which of them is in possession of the money.

Treating the contract as terminated from the date of the fraudulent act

3.16 Clause 12(3)(b) provides that an insurer exercising its right to treat CF's cover as being terminated from the date of the fraudulent act must serve notice to that effect on both A and CF.

No repayment of premium

3.17 Clause 12(3)(c) confirms that the insurer need not repay any of the premiums paid in respect of CF's insurance cover.

Contracting out of group insurance provisions

3.18 Clause 15 of the draft Bill provides that the insurer may not contract to put a consumer in a worse position than a consumer would be in under the provisions of the draft Bill.[11] The restriction also applies to members of a group insurance contract caught by clause 12. Consumer members of such a scheme cannot be put in a worse position by the terms of the policy than they would be in under clause 12. This is confirmed by clause 15(3)(b).

3.19 This means, for example, that an insurer may not provide that a fraudulent claim made by a member would allow the insurer to avoid the insurance cover from the outset, or that fraud by one member would affect the cover of all.

[10] Available at http://lawcommission.justice.gov.uk/docs/Insurance_stakeholder_notes_January_2014.pdf.

[11] See further discussion in the following Part.

PART 4: CONTRACTING OUT

BACKGROUND AND POLICY

4.1 The changes to insurance contract law contained in our draft Bill are mandatory for consumer insurance, following our approach in the Consumer Insurance (Disclosure and Representations) Act 2012 (CIDRA). For commercial parties, they are only intended to be a default regime. Non-consumer market participants should generally be able to contract out of the reforms and substitute their own agreed regimes.

4.2 However, we believe that the proposals represent a fair balance between the interests of insurers and policyholders. They are supported by the majority of consultees from all sides of the market. We wish to discourage boiler plate clauses which opt-out of the default regime as a matter of routine, particularly in the context of mainstream business insurance. The parties to an insurance contract should consider whether contracting out of any or all of the default provisions is appropriate in their particular circumstances. In sophisticated markets including the marine insurance market we expect that contracting out will be more widespread.

4.3 We do not propose to place any general restrictions on the *extent* to which the regime can be altered (or excluded) by contract. Parties may opt out of the vast majority of proposed changes entirely,[12] provided they meet two procedural requirements. These are referred to in the draft Bill as the "transparency requirements",[13] and are discussed further below.

CONSUMER INSURANCE CONTRACTS

4.4 Contracting out of our default provisions in the consumer insurance context is prohibited by clause 15 of the draft. This provision is based on section 10 of CIDRA.

4.5 It provides, at 15(1), that any policy term, or term in any other contract, is rendered void to the extent that it would put the consumer in a worse position than they would be in under our default provisions.

[12] Contracting out will not be possible in two circumstances. It will not be possible to use a basis of the contract or similar clause to turn all information on the proposal form into warranties. Also, it will not be permissible for an insurer to limit or exclude liability for damages for late payment of claims, but only where their failure to pay was deliberate or reckless.

[13] See clause 17.

4.6 The new provisions on warranties, remedies for fraudulent claims, late payment of insurance claims and good faith will therefore apply to all consumer insurance contracts as a mandatory regime.[14] Any clause of a consumer insurance contract which seeks to change the default rules will be subject to scrutiny. If the result of the term is that the consumer is worse off than they would have been under the default regime, the term will be of no effect.

4.7 Clause 15(3)(a) confirms that the restriction on contracting out in the consumer insurance context also applies to variations.

4.8 The restriction also applies to consumers who are beneficiaries of a group insurance contract caught by clause 12, which deals with fraudulent claims by group members. Consumer members of such a scheme cannot be put in a worse position by the terms of the policy than they would be in under clause 12. This is covered by clause 15(3)(b).

NON-CONSUMER INSURANCE

Our objectives

4.9 Restricting the ability of parties in the business insurance context to contract out of statutory provisions was a controversial issue. When we consulted on the issue we had strong support for including procedural requirements,[15] but there was significant concern that this would introduce uncertainty into insurance contracts and that insurers would find it difficult to know whether they could rely on a term until it had been tested in court. Some consultees, particularly at the more sophisticated and high-value end of the market, were sceptical of any approach that sought to impose restrictions on what they put in their contracts.

4.10 There are a number of important but competing concerns: the insurers' need for certainty, the principle of freedom of contract and the interests of insurance buyers whose negotiating power and understanding of legal insurance matters may be limited (such as quasi-consumer micro-businesses and SMEs purchasing off-the-shelf insurance online).

4.11 The requirements proposed are intended to balance those interests and achieve the following aims:

(1) To encourage insurers to consider whether opting out of the default regime is necessary or appropriate in the circumstances.

(2) To enable policyholders to make an informed decision (with or without the aid of a broker) about whether to agree the alternative position, to negotiate for the default position or to seek an alternative insurance provider.

[14] See clause 15(2). Part 2 of the draft Bill (fair presentation) does not apply to consumer insurance contracts. This is also true of clause 8, which deals with basis of the contract clauses. Both of these matters are dealt with in the consumer insurance context by CIDRA.

[15] See Warranties Summary of Responses, p18; Disclosure Summary p36; Damages Summary, p13; Fraud Summary, p15. Available from: http://lawcommission.justice.gov.uk/areas/insurance-contract-law.htm

(3) To ensure that the contracting out provisions are not so onerous as to interfere with the smooth running of the insurance market, particularly at the more bespoke and sophisticated end of the market.

(4) To give the courts room to differentiate between different scenarios, from well advised, commercially aware insurance buyers to small businesses buying "off the shelf" and, increasingly, online.

The transparency requirements

4.12 The transparency requirements are contained in clause 17 of the draft Bill.

4.13 Clause 17(1) provides that the transparency requirements apply to any "disadvantageous term". A disadvantageous term is one which would put the insured in a worse position than they would be in under the default rules.[16]

4.14 A disadvantageous term is of no effect unless both of the transparency requirements are fulfilled. Those requirements are:

(1) The insurer must take sufficient steps to draw the disadvantageous term to the insured's attention before the contract is entered into (clause 17(2)); and

(2) The disadvantageous term must be clear and unambiguous as to its effect (clause 17(3)).

A subjective application of the transparency requirements

4.15 Clause 17(4) provides that, in determining whether the transparency requirements have been met, the characteristics of insured persons of the kind in question should be taken into account, as should the circumstances of the transaction.

4.16 This means that an insurer should take more care when dealing with less sophisticated insurance buyers, perhaps buying 'off the shelf' insurance coverage without the help of a broker, than when dealing with a well advised, experienced buyer of insurance cover.

4.17 At the end of this document we give some examples illustrating how we think this will work in practice.

Drawing the insured's attention to the disadvantageous term

4.18 This requirement, in clause 17(2), aims to ensure that insureds are given a reasonable opportunity to know that the disadvantageous term exists. A term which puts the insured in a worse position than the default regime should not generally be buried in a policy document without any further reference to, or discussion about, it.

[16] Clause 16(1). This is subject to two exceptions, set out in clause 16(3) and discussed below.

4.19 As we have said, this test needs to be interpreted flexibly to take account of the full range of participants in the insurance market. The extent to which a term should be brought to the attention of a policyholder will vary considerably depending on whether the policyholder is, for example, a sole trader buying standardised retail public liability insurance or a charterer purchasing a voyage policy at Lloyd's using a broker.

Term to be clear and unambiguous as to its effect

4.20 Clarity and a lack of ambiguity are basic requirements and are already well established in common law. They relate to a broader concept of transparency which, in various forms, appears frequently in consumer protection legislation but is not out of place in the business insurance context where there is often an imbalance of negotiating power between the parties.

4.21 The requirement in 17(3) goes slightly further, in that it requires the effect or *consequences* of the disadvantageous term to be clear and unambiguous. For example, it would not normally be sufficient to say that "Section 13 of the Insurance Contracts Act 20XX does not apply to this contract", despite the fact that this is clear and unambiguous in itself. Rather, an insurer wishing to contract out of its duty to pay sums due within a reasonable time might have to say that "Section 13 of the Insurance Contracts Act 20XX does not apply to this contract, meaning that we shall have no liability to you in respect of any loss or damage suffered by you as a result of our failure to pay sums due to you under this contract within a reasonable time".

4.22 The requirement should not be equated with the *contra proferentem* rule, under which any ambiguity in a term will be construed against the party seeking to rely upon it. If a clause fails to meet the transparency requirements, it will be of no effect and the default rules will be applied instead.

4.23 Again, how far the term has to spell out the consequences will depend on the nature of the insured party and the extent to which they could be expected to understand the consequences of the provision.

Two exceptions from contracting out

Basis of the contract and similar clauses

4.24 By the very nature of the prohibition of basis of the contract clauses in clause 8, it will not be possible to contract out of this. This is confirmed by clauses 16(2) and 16(3)(a).

4.25 Insurers will not be able, by any formulation of words, to provide that any or all of the pre-contractual representations made by a (prospective) insured automatically become warranties. If an insurer wants a warranty in respect of any particular matter, this must be specifically agreed between the parties.

Deliberate or reckless late payment of insurance monies

4.26 In non-consumer insurance contracts, insurers will generally be able to contract out of our implied obligation, contained in 13(1), as to payment within a reasonable time. That is, insurers will be able to exclude or limit their liability for breach of the duty to pay within a reasonable time, or provide that the implied term does not apply to a particular insurance contract, provided they comply with our transparency requirements.

4.27 However, insurers may not limit/exclude liability for breaches or exclude the application of the implied term where their failure to pay within a reasonable time is deliberate or reckless. This limitation is contained within clause 16(2) and 16(3)(b), which provide that any attempt to contract out of liability for a deliberate or reckless breach of the implied term about payment will be of no effect.

4.28 Under 16(5), a breach is "deliberate or reckless" if the insurer knew it was in breach of the term or did not care whether or not it was in breach. This will cover circumstances in which the insurer refused a valid claim or failed to pay within a reasonable time either knowing or not caring that it was doing (or failing to do) so.

SETTLEMENT AGREEMENTS

4.29 Our contracting out provisions do not apply to settlement agreements. We would not wish to prevent valid settlements, or call their validity into question, even if the insured settles on less favourable terms than a court would have awarded.

4.30 This means that, where a settlement has been reached in the consumer insurance context, the prohibition on less favourable terms than the default rules does not apply. In the non-consumer context, there is no requirement to meet the transparency requirements in the context of settlement agreements.

4.31 This is confirmed in clauses 15(4) (consumer) and 16(6) (non-consumer).

CANCELLATION RIGHTS

4.32 We do not wish to hinder the ability of parties to make provision for cancellation. Cancellation clauses are currently used by insurers in many contracts and generally allow the insurer to terminate the contract on giving a specified period of notice. The right may be exercisable in specified circumstances or for any reason. As they operate prospectively, the insured is not put in a worse position than they would be in under the new rules: they will be aware that they no longer have insurance cover and able to take out new insurance. The right to cancel is usually tied to an obligation to return any paid premiums on a pro-rata basis. The policyholder's past claims will still be payable (unless the insurer has a remedy for non-disclosure or some other breach).

4.33 The transparency requirements do not therefore apply to cancellation clauses.

EXAMPLES APPLYING THE TRANSPARENCY REQUIREMENTS

Example 1: Small business purchasing standard form insurance online

4.34 **Scenario 1:** The owner of a small business (B) visits an insurance company's (C) website to purchase public liability insurance. B fills in the requisite forms online, is given an automatically generated quote and is then asked to indicate whether or not he wishes to proceed. At this stage there is a large box on screen showing the key terms of the policy: premium, extent of coverage, etc. B has to tick a box stating that he agrees to the standard terms and conditions attached to the insurance policy. There is a link next to the box which, if clicked, opens a window showing all of the standard terms. A term excluding liability for damages for late payment (ie excluding liability for breach of the implied term in clause 13(1)) is included at paragraph 24. There is no other reference to the term.

4.35 We do not think the transparency requirement in clause 17(2) has been satisfied here. The policy would still exist but the term purporting to exclude liability for damages for late payment would be of no effect.

4.36 **Scenario 2:** As above, but this time the box detailing the key terms also states: "The insurer will not be liable to pay you damages if you suffer loss as a result of a delayed or wrongly refused claim. Please see paragraph 24 of our standard terms and conditions for further details" That wording is one of only five points appearing in the "key terms" box.

4.37 We think this would be sufficient (assuming paragraph 24 is appropriately worded) to exclude liability for late payment of claims. C has taken active steps to draw B's attention to the specific term that excludes liability. B was presented directly with this term, and had the option of purchasing the insurance, investigating further, or abandoning the purchase. There was little more the insurer could do in the context to bring the clause to B's attention.

Example 2: Medium-sized enterprise buying insurance through a regional/non-specialist broker

4.38 **Scenario 3:** The managing director of a medium-sized enterprise (M) visits an insurance broker (IB) to discuss purchasing a bespoke liability policy to cover any liabilities arising from the manufacture, sale and use of a new product. IB discusses M's needs and agrees a set of requirements. IB then telephones a number of underwriters. Underwriter U offers the best price. IB and U discuss and negotiate certain terms of the insurance policy including price and coverage, and U states that the policy will, other than the negotiated terms, be on its standard terms and conditions. U emails a scanned copy of those conditions to IB. These include, at paragraph 24, a term stating that if any of M's employees have given a dishonest answer to M's "reasonable search" for information conducted under the fair presentation requirements, U is entitled to avoid the contract ab initio. This provision has the effect of modifying the fair presentation duty and U's remedy for breach. U did not mention this on the telephone. Paragraph 24, along with a handful of other terms, is marked with an asterisk. IB consults with M, not mentioning paragraph 24. M is pleased with the price and instructs IB to purchase the policy. IB relays this to U, who asks if IB has had a chance to go through the standard terms. IB replies in the affirmative and arranges for the policy to be entered into.

4.39 This would be at the limit of what was sufficient to bring the term to the notice of the insured (through its agent), but nevertheless we think this term would be effective. U has taken steps to draw IB's attention to the clause (which sets out relatively clearly the consequences of an employee's dishonesty). Although U hasn't done a lot, they have done what they have knowing that they are dealing with a broker. This would be a question of evidence, but we think that U should be entitled to rely on the broker actually reading the terms, or at least those that U had marked out for special attention.

4.40 This is also an example of the way in which our reforms would treat the relationship between broker and insured: U has done enough by telling the broker, and does not have to go directly to the insured. Naturally, if the IB does not advise M of paragraph 24 and M suffers loss as a result, M might seek to bring a claim against IB for failing to identify and explain the clause.

4.41 **Scenario 4:** As above, but M deals directly with U, without the benefit of a broker.

4.42 In this scenario, we do not think that U has done enough to satisfy clause 17(2). Unlike during their dealings with IB, U cannot assume that M will go through the standard terms, even when some were highlighted. Had they mentioned it to M on the phone, or in the covering sheet or email with the scanned standard terms, we think they would have satisfied the requirement.

Example 3: Sophisticated insurance buyer purchasing cover through Lloyd's

4.43 **Scenario 5:** One year after the coming into force of the new Act, Lloyd's underwriters and brokers have developed standard wordings to disapply the Act's reforms on warranties (so that breach results in discharge of all liability) and late payment (complete exclusion of liability). These standard wordings are assigned codes of LC1 and LC2 respectively. When a broker is negotiating a policy, if it is agreed that any of those will apply, the broker jots the code down on the slip, and this is taken as evidence that the terms are agreed and incorporated into the insurance policy.

4.44 S has just chartered a ship to carry cargo. S calls its broker (IB) in London and asks IB to arrange cover for the voyage, which must be in place by the time the ship sails in 24 hours time. IB negotiates with several underwriters at Lloyd's before finding one (U) who agrees to underwrite the voyage on favourable terms. However, U insists on excluding liability for damages for late payment, and is particularly keen that if S's ship strays from its proposed course (which S has warranted it will not) then the policy should be permanently terminable, so wishes to exclude the warranties reforms. IB, with authority to bind S, accepts this, and writes LC1 and LC2 on the slip which is stamped by U.

4.45 This assumes that the standard wordings agreed in the market are clearly drafted as to their effect. We think U's exclusions are effective, and they have satisfied the transparency requirements. This is a fast-paced market, and we would not want to interfere unnecessarily with its operation. The provisions have been discussed with IB who ought, as a broker, to know what LC1 and LC2 mean or to find out before binding his or her client.

4.46 **Scenario 6:** As above, but U does not mention LC1 or LC2, or its desire to exclude certain portions of the Insurance Contracts Act 20XX. Instead, it refers to its standard voyage conditions (coded U1VOY1). Those conditions have recently been updated to include terms substantively the same as LC1 and LC2. The broker writes a reference to those conditions on the slip and the policy is concluded.

4.47 We think these exclusions could be held to be ineffective if the matter was to come before a court. U has not done anything at all to bring IB's attention to the inclusion of the terms in its own standard terms. However, it would depend on the exact circumstances of the case: for example, the extent to which the detail of U1VOY1, as recently modified, was known by brokers generally; the availability of U1VOY1 for inspection; and the extent to which other standard sets of voyage conditions would be known by brokers to include such exclusions. We think an insurer in such a situation would be well advised to mention the specific provisions to the broker, perhaps in an email or by having them specifically noted on the slip.