Insurance Contract Law
SUMMARY OF RESPONSES TO THIRD CONSULTATION PAPER
The Business Insured's Duty of Disclosure and the Law of Warranties
Chapter 1: The Business Insured's Duty of Disclosure

This document summarises the responses to chapter 1 of the Law Commissions' third consultation paper in the joint insurance law project

March 2013

THE LAW COMMISSION
THE SCOTTISH LAW COMMISSION

Joint Review of Insurance Contract Law

SUMMARY OF RESPONSES TO THIRD CONSULTATION PAPER: THE BUSINESS INSURED'S DUTY OF DISCLOSURE AND THE LAW OF WARRANTIES

Chapter 1: The Business Insured's Duty of Disclosure

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Approach taken in this paper

Describing responses

This paper describes the responses we received to the proposals on business disclosure set out in our joint Consultation Paper: The Business Insured's Duty of Disclosure and the Law of Warranties. This document aims to report the arguments raised by the consultees. It does not give the views of the Law Commission or the Scottish Law Commission.

Comments and Freedom of Information

We are not inviting comments. However, if having read the paper you do wish to put additional points to the Commissions, we would be pleased to receive them.

Please contact us:

By email at commercialandcommon@lawcommission.gsi.gov.uk

By post, addressed to Dr Caroline Sijbrandij, Law Commission, Steel House, 11 Tothill Street, London SW1H 9 HL

We will treat all responses as public documents. We may attribute comments and publish a list of respondents' names.

Information provided, including personal information, may be subject to publication or disclosure in accordance with the access to information regimes (such as the Freedom of Information Act 2000, the Freedom of Information (Scotland) Act 2002 and the Data Protection Act 1998). If you wish your response to be confidential please explain why. While we will take full account of your explanation, we cannot give assurances that confidentiality will be maintained in all circumstances.

PART 1
INTRODUCTION

1.1 The Law Commission and Scottish Law Commission are carrying out a major review of insurance contract law. As part of that review, in June 2012, we published a joint Consultation Paper on "The Business Insured's Duty of Disclosure and the Law of Warranties".[1] The first chapter considered the business insured's duty to give information to an insurer before the inception of the contract. This paper covers the five areas dealt with by the chapter:

(1) The need for reform;

(2) Amending the disclosure test;

(3) Knowledge of the business, its agents and the insurer;

(4) Insurers' remedies for disclosure failures;

(5) Good faith.

1.2 The Marine Insurance Act 1906 places an onerous duty of disclosure on a business policyholder. Under section 18(1) a policyholder must disclose "every material circumstance" which it knows or ought to know "in the ordinary course of business". Under section 18(2) a material circumstance is defined as "every circumstance which would influence the judgment of a prudent insurer in fixing the premium, or determining whether he will take the risk". The statute does not require the insurer to ask questions or indicate what it wishes to know. Instead, the policyholder must work out what a hypothetical prudent underwriter would consider relevant.

1.3 We proposed that section 18 should be updated to incorporate and develop the best aspects of case law from the last 100 years. This would emphasise that the insured does not have to disclose every material circumstance, but must instead provide a fair summary of material circumstances – or as the current case law puts it, provide a "fair presentation of the risk".

[1] Insurance Contract Law: The Business Insured's Duty of Disclosure and the Law of Warranties, the Law Commission and the Scottish Law Commission, LCCP 204 / SLCDP 155 (June 2012) (hereinafter referred to as the "Consultation Paper").

1.4 The issue of knowledge within a corporate entity is important for business insureds, brokers and insurers alike. The 1906 Act frames the insured's duty of disclosure by reference to information known by the insured and its agent, and excludes from the duty information already known to the insurer. The 1906 Act does not indicate whose knowledge within an organisation is relevant, however, leading to considerable difficulties in applying the law to modern corporate organisations, in which knowledge may be spread through hundreds, if not thousands, of employees or located in IT systems. Nor does the Act specify what a business "ought to know". We made proposals for clarifying these concepts for businesses, brokers and insurers alike.

1.5 Under the current law, the only remedy for disclosure failures is avoidance: the insurer may treat the policy as if it never existed and refuse all claims. The insurer may even recover claims that it has previously paid to the insured. This remedy overprotects the insurer where it would still have underwritten the policy if the correct information had been supplied. It also fails to act as a sufficient incentive for insurers to ask questions. A policyholder who fails to mention a minor issue loses all benefit from the policy, even if the insurer would only have added a small amount to the premium had it known the true facts.

1.6 We proposed the introduction of a default regime of proportionate remedies, looking at what the insurer would have done if proper disclosure had been made. Where the insurer would have accepted the risk only on different terms, the contract will be treated as if it included these terms. Where the insurer would have charged a higher premium, claim payments will also be reduced proportionately. This regime will only apply where the policyholder has not acted dishonestly.

RESPONSES

1.7 We received 50 responses to our Consultation Paper, as shown in the table below. Many of the responses were from representative organisations, setting out the views of their members. This provided a good cross-section of those concerned with business insurance, and included the main industry bodies from each side of insurance transactions as well as significant market participants.

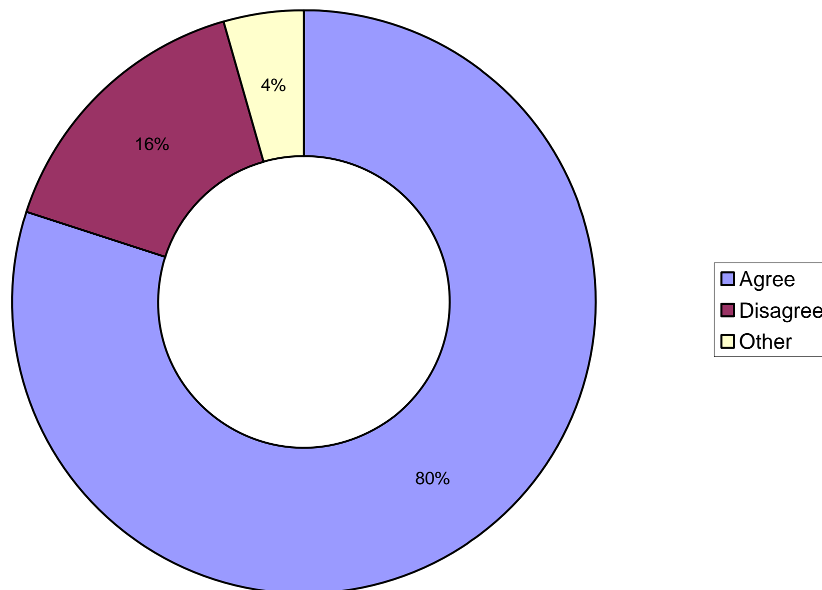
Type of respondent	Number
Insurers and insurance trade associations	16
Lawyers, legal associations and the judiciary	15
Brokers and brokers' associations	6
Academics	3
Policyholders and policyholder/consumer groups	3
Other	7
Total	50

THANKS

1.8 We would like to thank all the consultees who responded to our Consultation Paper, or who met with us or contacted us to express their views. Whilst we are unable to directly quote all consultees' submissions in this brief summary, all views are important to us as we put together our recommendations for the final report. A list of all the consultees is contained in the Appendix.

PART 2
THE NEED FOR REFORM

2.1 We asked whether consultees agreed that there is a need to reform sections 18 to 20 of the Marine Insurance Act 1906 to clarify the duty of disclosure in business insurance. Of 45 respondents to this question, 36 (80%) agreed that there is a need for reform.



Agreement

2.2 Respondents in favour of our reform proposals typically said that they would provide better balance between the interests of each party, and better reflect current commercial best practices. We received support from across the insurance market, including insurers, brokers and policyholders, as well as from lawyers, legal academics and members of the judiciary.

2.3 The Association of British Insurers (ABI) commented:

> The proposals appear to offer greater clarity for insureds in respect of their duty to disclose and the impact of not disclosing material information. It is in the interests of both insurers and insureds that the duty of disclosure has been complied with, leading to greater certainty that risks are correctly assessed and priced and coverage will be assured.

2.4 The British Insurance Brokers' Association (BIBA) was also supportive:

> BIBA strongly agrees that the changes are necessary to maintain London's pre-eminence in the insurance world.

2.5 Royal & Sun Alliance Insurance (RSA) agreed that many market participants struggle to understand what the law currently requires:

> In our experience many in the commercial insurance market (be they insureds, brokers and, indeed, insurers themselves) do not properly understand the operation of these sections of the Act and the disclosure-related legal duties and rights that flow from them.

2.6 The Chartered Insurance Institute (CII) agreed with the need for reform, saying that while the duty to disclose information is critical, "the current law… places the onus to identify what is material solely on the customer who in reality often is not aware of all the information". K&L Gates LLP said:

> We fully agree with the Law Commission on the need for reform of this area of the law which is out-dated for modern business practices.

2.7 Professor John Birds agreed with the call for reform, saying that "given the developments since the 1906 Act… this would be eminently sensible".

2.8 The risk managers' association Airmic, which represents the insurance buyers and claims handlers for about 75% of FTSE 100 companies and a substantial number from FTSE 250 and smaller firms, reported that their members were "overwhelmingly in favour of reform". Mactavish, an insurance research and consultancy firm, strongly agreed with our identification of the problems and stated:

> The current corporate insurance market is characterised by too much coverage uncertainty, too many disputes, too much leverage of dispute potential in negotiation and too little work to narrow scope for dispute at the placement stage.

2.9 A large proportion of the insurers who responded concurred that the law is in need of reform. These included Direct Line Group, RSA, AXA Corporate Solutions Assurance (AXA), Chartis and NFU Mutual Insurance Society (NFU Mutual). The insurers' organisations GRiD and the Investment & Life Assurance Group (ILAG), representing group risk insurers and life insurers respectively, also agreed that there is a need for reform.

Disagreement and concerns

2.10 Seven respondents (16%) disagreed that there is a need for reform, while two respondents (4%) reported that they were unsure.

2.11 Many of those who doubted the need for reform are participants in specialist insurance markets, such as Lloyd's, in which large and complex risks are insured or reinsured. In particular, the International Underwriting Association (IUA), Swiss Re Europe, and Catlin disagreed, while the Lloyd's Market Association (LMA) questioned whether there was a need for reform.

2.12 The reasons put forward by those who saw no need for change were that the law is well understood and causes few disputes; that the UK insurance market is internationally competitive; and that business policyholders are sophisticated and are professionally advised by brokers.

2.13 Swiss Re covered many of these points in their response:

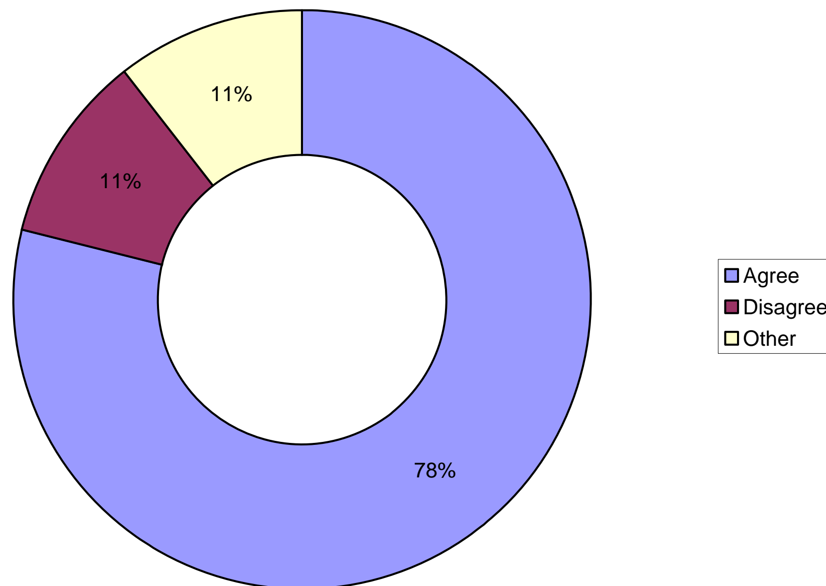
> The key principles of the Act are well established and supported by the flexibility of the judiciary, and the UK remains a very competitive legal market. For this reason, English law is often chosen or business written in the UK even where the insured and insurer have little or no connection to the UK. We do not believe current UK insurance law is having a detrimental effect on the market.
>
> Moreover, as regards business insureds, we do not agree that policyholders fail to understand the law or their duty of disclosure. Business insureds are very different from consumers and this fails to take into account the role or expertise of the professional broker.
>
> As a reinsurer seeing submissions from insurance companies either directly or via professional brokers, both of whom understand fully the duty of disclosure, we see even less reason for reform.

2.14 The IUA opposed radical change to the rules on disclosure, but welcomed incremental reform:

> We continue to believe that a compelling case for fundamental statutory reform to the law on business insurance contracts has not been made, either legally or economically. That said we do appreciate and support the approach taken by the Law Commission to improve the risk presentation process and dialogue between the contractual parties (including brokers). Increased clarity and transparency in the presentation process and a reduction in disputes benefits all parties and allows insurers to more accurately assess and price risks to the ultimate benefit of policyholders.

THE REFORM SHOULD APPLY TO ALL BUSINESSES

2.15 In 2009 we proposed special protections for micro-businesses.[2] After considering the matter further, however, we decided not to proceed with this proposal.[3] In the Consultation Paper, we asked consultees whether the same legal regime should apply to all businesses, both large and small. Of 38 respondents to this question, 30 (78%) agreed that there should be a single disclosure regime for all businesses.



Agreement

2.16 Respondents agreed that implementing a split between small and large businesses would be fraught with difficulty. Berrymans Lace Mawer (BLM) said that it would be "unduly complex and onerous", while Keoghs commented that a split would not be "practical or equitable" and BIBA called it "unwieldy". Addleshaw Goddard favoured a single regime on the grounds of "consistency and certainty". Allen & Overy (A&O) agreed that separate regimes would introduce uncertainty and reported their experience that "small businesses may be highly sophisticated in their understanding of insurance".

2.17 Several respondents said that smaller businesses could obtain advice from brokers. Catlin said that insureds are "able to choose a broker who will assist them with their insurance needs", although they noted that this advice may come at a higher price. John Habergham of Myton Law agreed and reported that all of the cases that he had dealt with "involve[d] placement by a broker, regardless of the size of the insured".

[2] Issues Paper 5, Reforming Insurance Contract Law: Micro-Businesses (April 2009).

[3] LCCP 204/SLDP 155, Appendix A.

2.18 Respondents also cited the protection offered by the Financial Ombudsman Service (FOS) to small businesses as undermining the need for a separate regime. The IUA said that they are "comfortable… that micro-businesses do not need additional statutory protection".

Disagreement

2.19 Four consultees (11%) expressly disagreed with a single regime for all businesses.

2.20 Philippe Chennaux, a risk and insurance consultant, said that "small businesses are more often than not run by individuals" and "not all of them can afford risk managers and/or lawyers to guide them".

2.21 The Bar Council, the Law Society of Scotland, and the British Insurance Law Association (BILA) all disagreed with a single regime, for largely the same reasons. These consultees argued that small businesses tend to contract on insurers' standard terms and increasingly apply for insurance online without the assistance of brokers. Smaller businesses may lack the ability to take disputes with insurers to court, though it was also suggested that the courts were diluting commercial certainty in order to do justice for small businesses. All three respondents acknowledged that drawing a line between small and large businesses would be difficult, but thought that the exercise was worth pursuing.

Concerns

2.22 Mactavish agreed with a single regime but wished to see "a degree of proportionality" in the standard of disclosure required. A broker, whose response was given to us in confidence, commented that there is a greater likelihood of a small business failing to understand what is required of them, but thought that "codified protection is not the answer". It thought that the risks for small businesses could be diminished by increased awareness and guidance about the requirements of disclosure.

2.23 The law firm Browne Jacobson commented that improved protection for small and medium sized enterprises should be delivered by increasing the FOS's jurisdiction rather than changing insurance law.

2.24 The Financial Ombudsman Service itself responded that it had considered complaints from small businesses for many years and had "not encountered any significant issues or difficulties in deciding whether a business is a micro-enterprise [falling within their jurisdiction]". However, the FOS acknowledged that their approach "depends entirely on the circumstances of the individual case" and recognised that their experience might not translate to other contexts.

PART 3
AMENDING THE DISCLOSURE TEST

ESSENTIAL ELEMENTS OF SECTION 18

Retention of essential elements

3.1 We asked consultees whether the essential elements of section 18(1) of the Marine Insurance Act 1906 should be retained, so that before entering into an insurance contract, a business policyholder should disclose material circumstances which it knows or ought to know. Of 42 respondents to this question, 38 (91%) agreed that the current onus on the business to make disclosure should remain.

Agreement

3.2 Support for retaining the duty of disclosure was considerable. Agreement was received from policyholders and brokers as well as insurers. A common theme was that while the duty should be retained, insurers should be encouraged to become more active in guiding disclosure by insureds. This approach emerged from the responses of Heather Thomas, Geoffrey Lloyd, RWA Group, the Chartered Insurance Institute (CII) and K&L Gates in particular.

3.3 Airmic responded that their members were substantially in agreement with retaining the essential elements of section 18, but reported that one member had commented that insurers should "provide guidance" as to what they consider to be material facts.

3.4 Direct Line Group provided a balanced response, accepting that insurers "ought to be able to identify what is key to the presentation [of the risk]", but pointing out that the duty was needed "given the diverse and complex nature of commercial products and risks". The Association of British Insurers (ABI) provided similar rationales for the duty, commenting that businesses have the best awareness and understanding of their complex risks and are not in need of special protection.

3.5 One response from a broker commented that the abolition of the duty "would create an unduly onerous burden on all parties to ask the right questions and elicit the necessary responses".

Disagreement and concerns

3.6 Only one consultee disagreed that responsibility for making disclosure should continue to rest with the business. Peter Patient called disclosure an "arcane concept which needs a radical overhaul" and suggested that:

> …the emphasis should be on insurers to ask the appropriate questions directed to the appropriate people of the businesses.

3.7 Allen & Overy (A&O) responded that while they did "not disagree that policyholders need to undertake the task of placing insurance with care", the policyholder's duty should be shaped by requiring insurers to identify key questions to be addressed. Similarly, a broker, whose response was given in confidence, said that they would prefer to see a move to an "insurer-led questions-based model" but that the starting point should remain with the insured.

Clarification of "material circumstances" and "knowledge"

3.8 We asked consultees whether, if the essential elements of section 18 of the 1906 Act are to be retained, the concepts of material circumstances and knowledge ought to be clarified. Of 43 respondents to this question, 34 (79%) agreed.

Agreement

3.9 Those consultees who provided reasons for agreeing with the proposal tended to see increased certainty as a benefit. Royal & Sun Alliance Insurance (RSA) said:

> Unless these concepts are clarified neither the insured nor the insurer will be provided with the sufficient level of certainty necessary to enable them both to confirm that the insured's duty of disclosure has in fact been complied with… .

3.10 Addleshaw Goddard agreed with the need for clarification, commenting:

> [Given] the lack of guidance as to what might be material from the perspective of the policyholder, one can understand how difficult it must be for businesses to decide what ought to be disclosed.

3.11 The ABI said that clarification of these concepts was "crucial to the success of the reforms", but reported that some of its members favoured a non-prescriptive approach over a statutory definition. The British Property Federation responded that clarification of the definition of material information "will help to guarantee that insurers and policyholders are operating in a far more transparent environment".

3.12 A&O commented that the concepts "would certainly be more readily understood if contained in statute" and called this an "important step in the right direction", but warned that codification might not make the concepts much clearer.

Disagreement and concerns

3.13 The five consultees (12%) who disagreed with this proposal thought that the concepts were already made clear by the case law and should be left to the courts (one of the five did not object to strict codification). The Lloyd's Market Association (LMA) and Catlin also argued that legislation would introduce uncertainty and potentially cause litigation.

3.14 Four consultees (9%) were classed as "other". These consultees argued either that no reform to disclosure should be pursued at all (three consultees) or that disclosure should be abolished entirely (one consultee).

A FAIR PRESENTATION OF THE RISK

Duty to make a fair presentation

3.15 We asked consultees whether material circumstances should be specified as those required to provide the insurer with a fair presentation of the risk. Of 42 respondents to this question, 30 (71%) agreed with the proposal.

Agreement

3.16 Many consultees commented that fair presentation was an appropriate standard by which to assess disclosure. Berrymans Lace Mawer (BLM) said that this move would:

> …clarify the extent of a policyholder's obligations and encourage insurers to make further inquiry upon a fair presentation of the risk.

Professor John Birds called fair presentation "the right starting-point" and the CII said that our proposals around fair presentation seemed "sensible". Airmic reported that their members were "overwhelmingly in favour of the idea".

3.17 K&L Gates agreed that fair presentation was an appropriate standard but asked that the legislation provide guidance as to what would constitute a fair presentation. Direct Line cited work by Airmic to produce industry guidance on risk presentation and said that this was "an opportunity for the insurance industry to work together to achieve clarity and consistency". By contrast, A&O reported that there would be difficulties preventing insurers and policyholders from working together on guidance and questioned the incentive for participants to follow any guidance which results, although they supported our proposals overall.

Disagreement

3.18 Three consultees (7%) disagreed with the fair presentation test. Claims Against Professionals (CAP) responded that there was no need to codify the fair presentation standard, arguing generally that there was no need to reform or codify the existing law. The LMA and David Hunter argued for retention of a test for material circumstances based on the question of whether the information would influence the judgment of a prudent underwriter. The LMA said that defining material circumstances by reference to a fair presentation was "circular" and that the insured is "protected by the existing (uncodified) legal tests of waiver and inducement". Nevertheless, the LMA did agree that fair presentation "is a useful concept to encapsulate a presentation of material circumstances…".

Concerns

3.19 A number of consultees urged caution in codifying the fair presentation concept or questioned whether codification was desirable. Concerns were received from the International Underwriting Association (IUA), Catlin and Keoghs. These consultees suggested that this concept might be better left to judicial discretion and saw a risk of increased litigation if the concept were codified.

3.20 Several consultees thought that our proposal did not go far enough. The London & International Insurance Brokers' Association (LIIBA), along with a further broker whose response was received in confidence, argued that legislation should provide an exhaustive list of circumstances requiring disclosure, which would fully set out the insured's duty. Additionally, Marsh said that the definition should provide further clarification of material circumstances. By contrast, GRiD responded that legislation should not restrict an insurer's areas of enquiry. Zurich asked for confirmation that "data dumping" – that is sending huge quantities of unstructured information which insurers have little opportunity to read or consider – would not constitute a fair presentation.

Elements of a fair presentation

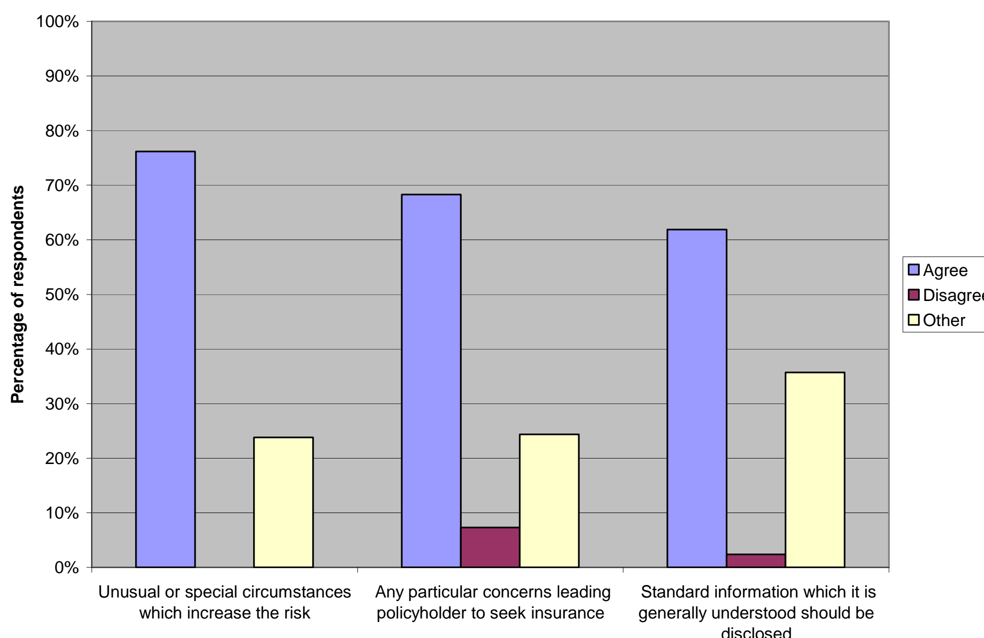
3.21 Our analysis in the Consultation Paper of the case law on material circumstances showed that the courts have considered there to be three categories of information which must be disclosed for a presentation to be fair. These are:

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

(2) any particular concerns about the risk which led the policyholder to seek insurance;

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

We asked consultees whether they agreed that this information was required for a fair presentation of risk. These propositions received the support of 76%, 68% and 62% of consultees respectively.



Agreement

3.22 Strong support was received for all proposed necessary elements of a fair presentation. The IUA agreed with the proposal, saying that:

> These inclusions reflect the direction of the judiciary, which we do not find objectionable, and have the benefit of already being well known and relatively clear to the parties.

3.23 The IUA said that the proposals would increase interaction between the parties at the pre-placement stage in both standardised and bespoke markets. They reported that the proposal would increase clarity in standardised markets, although the parameters would remain flexible for "new, complex or specialist risks, particularly where the risk is underwritten on a subscription basis", where standards necessarily differ.

3.24 BLM similarly reported:

> There is an extensive understanding of "market standard information" but the difficulty will always lie at the periphery of evolving practice and knowledge.

3.25 Reynolds Porter Chamberlain (RPC) agreed that market participants should work together to agree standard information for particular insurance markets and foresaw benefits from the endeavour:

> This provides opportunity for the insurance market to develop disclosure protocols on what amounts to the key material facts for specific categories of risk. This would be an effective method of clarifying what it is generally understood should be disclosed in relation to particular risks. It could also increase efficiency in the underwriting process.

3.26 Likewise, the Judges of the Court of Session felt that specifying in legislation that particular concerns of the insured leading them to seek insurance need to be disclosed would improve the disclosure process:

> This also helpfully directs the insured's directing mind toward matters that are relevant to put before the insurer.

3.27 A large number of comments and suggestions as to the details of these elements were provided by consultees, who nevertheless agreed with the proposals:

(1) In relation to unusual or special circumstances increasing the risk, a number of brokers commented that insurers should specify or indicate factors which they considered unusual or special. Two consultees argued that what is unusual or special should be judged from the perspective of the insured rather than the insurer. Comments were also received that insureds should only be required to disclose circumstances which are material.

(2) Many brokers commented that insurers should be responsible for providing checklists or other guidance as to what constitutes standard information in particular markets. On the other hand, the IUA argued that brokers should also bear responsibility as market participants and stressed that brokers

> …are best positioned to collate and assess risk information and profiles across their book of clients and benchmark these for standardisation.

Concerns

3.28 Keoghs replied that codification of fair presentation would be "too difficult when talking about business insurance" and would "inevitably lead to further litigation". The ABI, the Bar Council and K&L Gates also saw a risk of disputes in relation to what is standard information in particular markets.

3.29 Professor John Birds responded that whether the insured has made a fair presentation of the risk should be judged from the insured's perspective ("the reasonable insured" test[1]). RSA also suggested that fair presentation should be judged by a combined subjective and objective test of the insured's actions. Similar views were raised by K&L Gates and Mactavish in relation to standard information, with both arguing that what information is "standard" in a market would be unknown to insureds.

3.30 On the other hand, Professor Howard Bennett welcomed that the reasonable insured had "been, happily, laid to rest". Professor Bennett commented that the "root problem is the inability or unwillingness of assureds to think about insurance risk from the perspective of an insurer" and argued that it could only be solved by businesses taking insurance more seriously. While he understood "the exhortation towards development of protocols [for disclosure]", he commented that he was "unsure that a private law statute is the way to do this".

3.31 Some consultees stated that requiring the disclosure of particular concerns leading to the policyholder seeking insurance would be of limited effect as often the business's motivation will be general prudence or to comply with rules requiring compulsory insurance cover.

[1] We previously provisionally proposed a "reasonable insured test" in our first consultation paper on insurance contract law — Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured (2007) Law Commission Consultation Paper No 182; Scottish Law Commission Discussion Paper No 134.

Co-operation between insurers and policyholders

3.32 Many consultees agreed that our proposals would encourage insurers and policyholders to work together to improve pre-contract disclosure. Of 37 respondents to this question, 24 (65%) agreed. Where comments were given, these consultees were cautiously optimistic that interaction between the parties would increase, although the difficulty of predicting the future was acknowledged. Some consultees reported that they already worked closely with their counterparts. Many consultees commented that increased interaction pre-placement would be highly beneficial.

3.33 Only four consultees (11%) expressly disagreed that our proposals would encourage interaction. Of these consultees, only two argued that our proposals would harm pre-contract co-operation. Browne Jacobson asserted that our proposals on proportionate remedies (below at paragraphs 5.1 to 5.27) would reduce policyholder incentives to make full disclosure. CAP claimed that "the new proposals may lead to a more adversarial position between policyholders and insurers", resulting in data-dumping.

3.34 Of the remaining two consultees who indicated disagreement, David Hunter argued that co-operation had declined as a result of lowered professional standards and too great a focus on price. This should be addressed in preference to changing the law. Catlin argued that insureds should have a choice between interactive markets and more transactional markets offering "speed, flexibility and low cost", implying co-operation is not always desirable or necessary.

WAIVER

Codification of the core rule

3.35 The doctrine of waiver has been developed by the courts to deny an insurer a remedy where they fail to make enquiries where prompted. We proposed that legislation should specify that insurers are not entitled to any remedy for non-disclosure where the insurer receives information from the insured pre-contract which would prompt a reasonably careful insurer to make further enquiries. Strong support was received. Of 39 respondents to this question, 31 (79%) agreed with codifying the core of the doctrine of waiver. Only 3 consultees (8%) expressly disagreed with the proposal.

Agreement

3.36 Airmic reported that their members believed the proposal would be "helpful in bringing clarity to the information that underwriters require". Mactavish viewed the proposal as an important reform:

> Putting this case-law on the statute books is a crucial step towards ending the culture of passive underwriting which is endemic across much of the industry.

Geoffrey Lloyd also stated that he considered the proposal to be a "crucial recommendation".

3.37 Many insurers agreed with the proposal. Direct Line said:

> It is reasonable to expect an underwriter to make those enquiries necessary to enable him/her to adequately and correctly assess the risk, with the caveat that this applies only for related facts.

The IUA agreed that this proposal struck a "reasonable balance" between insured and insurer. Swiss Re reported that insurers already made further enquiries in placement:

> In practice no underwriter would simply rely on disclosed materials without asking questions.

3.38 One consultee, K&L Gates, argued that our proposal should go further and prevent insurers applying a remedy for non-disclosure where "the reasonable insurer would have made its own, independent enquiries" without being prompted by information received from the insured.

3.39 Several consultees commented that an insurer should not be deprived of a remedy where the insured acts dishonestly, even if a reasonably careful insurer would have made further enquiries. Several consultees also argued that an insurer should not be treated as waiving disclosure of special or unusual circumstances under this proposal. Finally, some consultees wished the proposal to apply only to fresh information provided by the insured for the particular placement, and not to information already held by the insurer from previous policies.

Disagreement and concerns

3.40 Three consultees (8%) disagreed with our proposal. Five consultees (13%) were classed as "other".

3.41 Keoghs reported that they were against codification as the test "is inevitably fact specific" and thus they saw no benefit in including the doctrine in legislation. Several other consultees argued that there were risks in codifying the doctrine. CAP thought that it would undermine the insured's obligation to disclose and that there could be disputes as to what enquires are appropriate. Chartis indicated that they would support codification but cautioned that this should not upset the current balance between the parties. Chartis also argued that the commercial context in which an insurer operates should be considered.

3.42 Catlin said that the concept of a "reasonably careful insurer" was new and "fraught with difficulty". They also saw a risk of insureds deliberately holding back information in the hope that the insurer would fail to ask questions. The ABI reported that their members preferred retention of the "tried and tested" term "prudent underwriter" over any new concept.

Other aspects of waiver

3.43 We asked consultees whether they agreed that other aspects of the doctrine of waiver, outside the core concept, could be left to the courts. Very strong support was received. Of 34 respondents to this question, 31 (91%) agreed. No consultees expressly disagreed.

3.44 Several consultees commented that the courts are best placed to deal with these issues on the facts of particular cases and to develop the law incrementally.

3.45 Three consultees (9%) marked "other" in response to this question. K&L Gates repeated that our proposal (described above at 3.35) should go further, while the LMA repeated its objections to reform of disclosure overall. A broker sought assurance that we did not mean to remove items from the list of categories that need not be disclosed in section 18(3).

INDUCEMENT

Codification of the inducement principle

3.46 We proposed in the Consultation Paper that the inducement test should be included in any reformed legislation, though at present it exists only in case law. We said that to obtain a remedy for non-disclosure or misrepresentation, the insurer must show that without the non-disclosure or misrepresentation it would not have entered into the contract at all, or would have done so only on different terms. Substantial support was received both for the proposal and for our formulation of the test.

3.47 Of the 39 consultees who responded to the proposal for codification, 36 (92%) agreed. Unsurprisingly given the high level of consensus, few consultees supplied substantive comments as to the merits of codification. A number of consultees emphasised that, whilst they agreed with codification if the duty of disclosure is to be reformed, they were not in favour of reform more generally. Similarly, the only consultee to expressly disagree with this proposal, CAP, agreed that the inducement test should be included in legislation if reform proceeds.

3.48 Of the 41 consultees who considered our formulation, 36 (88%) agreed. Addleshaw Goddard agreed that our proposal is "effectively in line with the current inducement test". Most comments received concerned details of the test.

3.49 The IUA and AXA Corporate Solutions Assurance (AXA) commented that it should be clear in the test that the non-disclosure or misrepresentation need only be an effective cause of the underwriter's actions, not the main or only cause. Professor Howard Bennett commented that as regards a misrepresentation, the test should consider how the underwriter would have acted had the circumstances been accurately represented, rather than by reference to silence by the insured. Professor Bennett also commented that it is necessary to distinguish situations in which fraud is present, to which a relaxed test of inducement should apply.

3.50 Two consultees argued against our formulation of the inducement test. Philippe Chennaux responded that any move to make the insured's duty of disclosure less onerous should be balanced by shifting the burden on inducement to the insured by requiring them to show that the underwriter was not induced by their non-disclosure or misrepresentation. The LMA also responded that the formulation would be inappropriately burdensome for insurers if the "prudent insurer" test of materiality is substantially changed.

PART 4
KNOWLEDGE

KNOWLEDGE OF THE PROPOSER UNDER SECTION 18

Need for clarification

4.1 Section 18(1) of the 1906 Act requires a policyholder to disclose every material circumstance which it knows, and a business is "deemed to know every circumstance which, in the ordinary course of business, ought to be known by [it]". Thus the duty applies to information which a policyholder knows or ought to know. In a corporate context both concepts are problematic, particularly where the business is a large and complex organisation. We proposed that the rules governing the knowledge of a business should be clarified. Very strong support was received for this proposal. Of the 41 respondents to this question, 34 (83%) agreed.

Agreement

4.2 The Chartered Insurance Institute (CII) supported our analysis of the problems with the present section:

> We agree that the current wording of Section 18(1) of the MIA needs amendment because it does not reflect the complexities of corporate entities.

4.3 Professor John Birds agreed that clarification would be "very helpful given that there is some uncertainty at present". Geoffrey Lloyd also responded that reform would be helpful, and commented that while the process of clarification would not be easy, it would be "worth the effort".

4.4 Allen & Overy (A&O) agreed that the issue of knowledge needs to be addressed as it "can lead to confusion and unnecessary litigation". K&L Gates welcomed reform and reported that "issues on knowledge frequently lead to disputes with insurers under the current law". The Association of British Insurers (ABI) supported our proposals for clarification, saying that they would "provide more certainty and thereby reduce disputes".

Disagreement

4.5 The consultees who disagreed with clarification were those opposed to overall reform of insurance law. David Hunter replied that there was "nothing wrong" with the current law. Keoghs also thought that the current case law was adequate, as did Swiss Re. The Lloyd's Market Association (LMA) argued that new legislation would lead to disputes.

Our approach: three issues

4.6 In the Consultation Paper, we identified three issues with section 18(1) which need clarification. The first is whose knowledge is relevant when the business is a corporate entity. When these persons are identified, the next issue is what these people may be said to "know". The final issue is what a business "ought to know" about its operations.

Whose knowledge is relevant?

4.7 We asked consultees whether knowledge for a corporate policyholder should include information known to the directing mind and will of the organisation and to the persons who arranged the insurance on behalf of the organisation. Overwhelming support was received for both propositions. 90% of the respondents to each question agreed.

4.8 The International Underwriting Association (IUA) agreed that our propositions would "provide suitable clarity for insureds, particularly larger companies, whilst protecting insurers". Similarly, A&O said that these were "fairly sensible proposals" which would "go some way towards solving the serious problems faced by large organisations in fulfilling their disclosure obligations".

4.9 Many consultees who agreed with our suggestions provided comments on details. Several consultees, including the ABI and Catlin, emphasised that information should be taken as known to the insured if it is known to *either* the directing mind *or* the person arranging insurance. K&L Gates replied that parties should be able to nominate persons whose knowledge is attributed to the organisation, saying that this flexibility would be useful. Royal & Sun Alliance Insurance (RSA) commented that the knowledge of the person *responsible* for arranging for insurance should also be included where this is different from the person who actually arranged the insurance. AXA Corporate Solutions Assurance (AXA) asked how subsidiaries would be accommodated in the proposal.

4.10 The London & International Insurance Brokers' Association (LIIBA), British Insurance Brokers' Association (BIBA) and Marsh argued that the knowledge of the directing mind and will and the person arranging insurance should be conclusive of the insured's knowledge. By contrast, Claims Against Professionals (CAP) expressed concern that our propositions would restrict the scope of knowledge within an organisation. Likewise, Swiss Re thought that the knowledge of all "relevant persons" should be included, although they did not specify how this was to be defined.

Actual and blind eye knowledge

4.11 We proposed that "knowledge" should mean both actual knowledge and information which the organisation had purposefully avoided acquiring (so called "blind eye knowledge"). These propositions commanded very high levels of support. Actual knowledge was supported by 36 of the 37 respondents (97%) and blind eye knowledge by 33 (89%).

4.12 Few comments were received on these proposals. Mactavish asked how a deliberate failure to acquire information would be distinguished from a negligent failure. Several consultees, including the IUA, the ABI and NFU Mutual, thought that information which the insured negligently failed to discover ought to be included. On the other side, K&L Gates, agreeing with the proposal, responded that only information which the insured deliberately avoided acquiring should be considered known to the organisation.

Reasonable enquiries

4.13 Finally, we proposed that a business ought to know information that would have been discovered by reasonable enquiries which are proportionate to the type of insurance and to the size, nature and complexity of the business. A business needs to disclose anything which would have been discovered by such enquires. Strong support was received. Of 39 respondents to this question, 32 (82%) agreed.

4.14 K&L Gates agreed that this would be "an improvement on the current law". Similarly, Geoffrey Lloyd said that this duty is a "highly desirable objective" and Professor John Birds called it "very sensible". Berrymans Lace Mawer (BLM) anticipated that this proposal would encourage insurers and policyholders groups to agree "proportionate disclosure procedures".

4.15 Some concerns were received that this obligation would reduce certainty for an insured in respect of its disclosure duties. The Bar Council agreed with the proposal but thought there could be litigation about what would constitute reasonable and proportionate enquiries. Chartis also thought that there could be difficulties in interpreting this concept. The LMA disagreed with the proposal, saying that the question would be "highly fact-specific" and should be left to the common law.

KNOWLEDGE OF THE PROPOSER UNDER SECTION 20

Alignment with section 18

4.16 Under section 20 of the 1906 Act, the proposer is under a duty not to misrepresent material facts. The section distinguishes between representations of fact, which must be "substantially correct", and representations of expectation or belief, which must be made in good faith. In the Consultation Paper, we argued that it would be simpler and easier to apply the same knowledge test to both section 18 and section 20. We proposed that both sections should distinguish between matters which the policyholder knew or ought to know about and other matters. We received strong support for this proposal. Of 39 respondents, 30 (77%) agreed.

Agreement

4.17 Our proposal received support from a substantial number of insurance organisations, lawyers and policyholders. Direct Line Group agreed with "making the law clearer and simpler by applying the same standard of knowledge to both sections" and reported that "this is the stance currently taken by the Courts". Addleshaw Goddard responded that the "change will make the law simpler to understand and to administer" and K&L Gates agreed that the distinction is "overly complex and in need of reform". The Bar Council reported that alignment would be clearer as matters are often pleaded as both non-disclosures and misrepresentations. Airmic replied that their members were "overwhelming in favour" of this reform.

Disagreement and concerns

4.18 Seven respondents were not convinced that alignment is needed. Catlin, LIIBA and a broker responded that change was unnecessary. The Law Society of Scotland said that it was unconvinced that alignment would lead to greater certainty. The LMA also reported that it was unsure of the consequences of alignment. Chartis and CAP thought that a knowledge-based test was too subjective as against the existing law.

Accuracy of representations

4.19 We proposed that representations concerning matters which the policyholder knew or ought to know about must be true. Where the matter is not one that the policyholder knew or ought to know about the representation must be made in good faith. Both propositions received strong support. Of 37 respondents, 32 (87%) agreed with the former and 26 (70%) with the latter.

4.20 K&L Gates said that our "proposed re-casting of these sections is appropriate and sensible in the modern context". Most comments received on these propositions concerned the appropriateness of the good faith standard for representations about information which the policyholder did not know and was not reasonably required to know about. RSA agreed that good faith "is the appropriate test" and said that this should be required of all relevant persons in the policyholder's organisation. The ABI also agreed and reported that its members had suggested that good faith should be required of "anyone involved in the information gathering process".

4.21 Several argued that a policyholder must also have reasonable grounds for any representation about a matter which it does not know. Furthermore, GRiD and Investment & Life Assurance Group (ILAG) asserted that any answer to an insurer's question should be truthful, with GRiD submitting that the policyholder should "take all steps possible" to answer accurately. One consultee argued that insureds should not make any representations about matters not within their own knowledge.

KNOWLEDGE OF THE BROKER

Need for clarification

4.22 We asked consultees whether there is a need to clarify the scope and nature of section 19(a) of the 1906 Act, which governs the knowledge of an agent. Consultees strongly agreed that there is a need for reform. Of 34 respondents to this question, 27 (79%) concurred.

4.23 The IUA agreed that reform is needed:

> Though the legislation is uncomplicated, the differing interpretations of Section 19(a) by the judiciary, particularly the Court of Appeal decision in *PCW Syndicates* (which we would disagree with) provides for a stronger argument for reform.

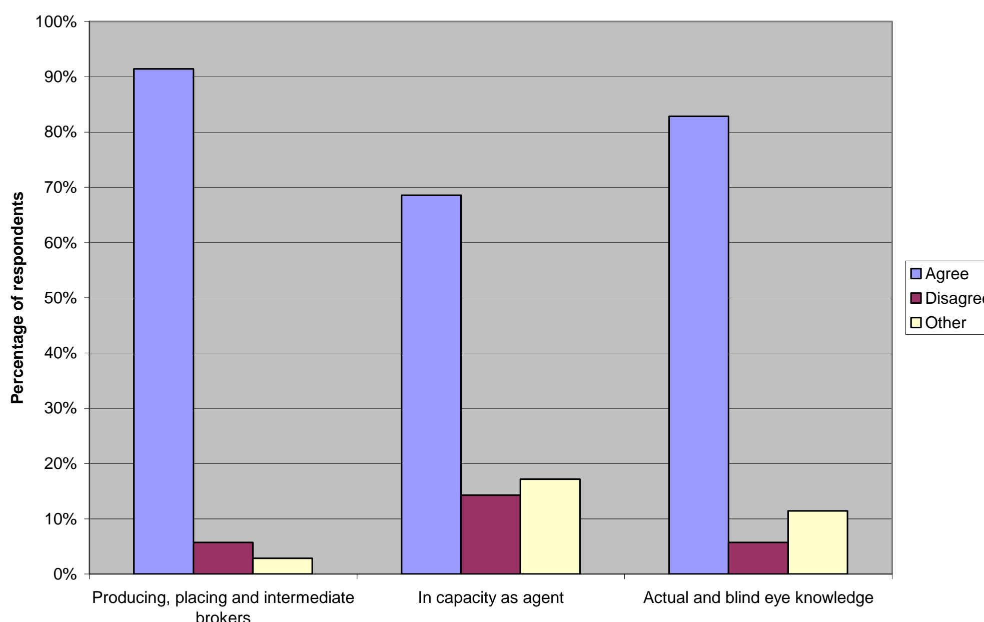
4.24 RSA also thought there was a "potential for ambiguity" in the current interpretations of the 1906 Act. The Judges of the Court of Session considered clarification necessary as the "precise ambit of the current provision is difficult to ascertain". Direct Line Group saw "little benefit in retaining the section as it stands". A confidential respondent reported that the section caused "significant concern for brokers". On the other hand, Catlin said that they were aware of few issues with the section in practice, though they acknowledged academic problems.

4.25 LIIBA, BIBA and Marsh stated their preference for repeal of the section in its entirety, but agreed with reform as a second preference.

4.26 Only two consultees expressly disagreed with the proposal. Swiss Re said that the section was "well understood currently" and CAP commented that "the existing legislation is sufficiently clear".

Broking chains, definition and source of knowledge

4.27 We proposed in the Consultation Paper to clarify that disclosure obligations apply along the broking chain, to producing, placing and intermediate brokers. We suggested, however, that an agent should only be obliged to disclose information received or held by it in its capacity as agent for the policyholder. We also proposed that agents should be deemed to know any information they had deliberately avoided acquiring. Strong support was received for all propositions. Of 35 respondents, 32 (91%) agreed with the first, 24 (69%) with the second and 29 (83%) with the third.



4.28 The IUA agreed that "all those in the chain of brokers should disclose relevant material facts within their knowledge" and that "confirmation of this in statute would be beneficial". BLM concurred that information should be passed along the broking chain and commented that the "complexity of relationships between policyholder and brokers is for the policyholder to manage". Only one consultee argued against extending disclosure obligations along the broking chain. Heather Thomas submitted that the obligation should be confined "to the placing broker to avoid endless complication".

4.29 Addleshaw Goddard said that restricting section 19(a) to information held by the agent as agent for the particular policyholder makes "sense and it is fair on policyholders". K&L Gates commented that the "change in law can only be correct". Swiss Re also agreed with the restriction, saying that "otherwise there may be a conflict of interest for the brokers". Many insurers argued, however, that agents should be obliged to disclose all information relating to the risk, held in whatever capacity, unless the information is confidential. They were joined in this submission by the Bar Council and British Insurance Law Association (BILA). These consultees pointed to risk management and other research work undertaken by brokers, which they felt should be disclosable. Contrastingly, one broker submitted that the agent's obligation should be limited to information acquired only in the course of placing the particular risk.

4.30 Few consultees commented on the inclusion of knowledge which an agent deliberately avoided acquiring. The ABI agreed that it would “make sense for the broker’s knowledge to reflect the categories of knowledge for insureds”. Reynolds Porter Chamberlain (RPC) submitted that the obligation should extend to knowledge which the agent is reckless in failing to acquire. LIIBA and a broker expressed concern that the proposal implied that brokers would be subject to an independent duty to acquire information about their client and argued that this would misconstrue them as principals to the contract.

Enquiries by brokers

4.31 We proposed in the Consultation Paper that where the broker is involved in carrying out reasonable enquiries on behalf of the business policyholder, an insurer should be granted a remedy where there is a failure to disclose information which would have been discovered by these enquiries. Strong support was received for this proposal. Of 37 respondents to this question, 27 (73%) agreed.

4.32 The ABI, along with RSA, responded that this proposal accords with current commercial practice and reflects the general law. Heather Thomas commented that our proposal was “the essence of the agency”. Mactavish replied that whilst this could seem unfair to the policyholder on a first reading, they agreed that “buyers of insurance ought to manage and take responsibility for the overall disclosure process”. K&L Gates said that the proposal appeared to be “fair and equitable”. RPC foresaw that our proposal would produce the “welcome effect of encouraging brokers to be more efficient in making enquiries of insureds at the time of placing”.

4.33 LIIBA, BIBA and Marsh did not expressly disagree with the proposal, but submitted that brokers should be under no greater obligation than the insured. Several consultees did object to granting insurers a remedy against policyholders where the broker fails to pass on information. Airmic, the Chartered Insurance Institute (CII) and RWA Group argued that it was unfair to hold the policyholder responsible for the broker’s failure.

Repeal of s 19(b)

4.34 In the Consultation Paper we noted that section 19(b) of the 1906 Act adds nothing to the policyholder’s duty of disclosure under section 18 and appears redundant. We therefore proposed its repeal. There was overwhelming support for removing this section, with 32 of 35 (91%) respondents in agreement.

4.35 Only two consultees provided arguments for its retention, with one calling it a “belt and braces” measure (John Habergham) and the other saying it was a “failsafe” which reduced arguments about the scope of the broker’s authority (the LMA).

KNOWLEDGE OF THE INSURER

4.36 In the Consultation Paper, we identified four main propositions from the 1906 Act and current case law concerning information which a policyholder need not disclose to an insurer in the absence of inquiry. These are:

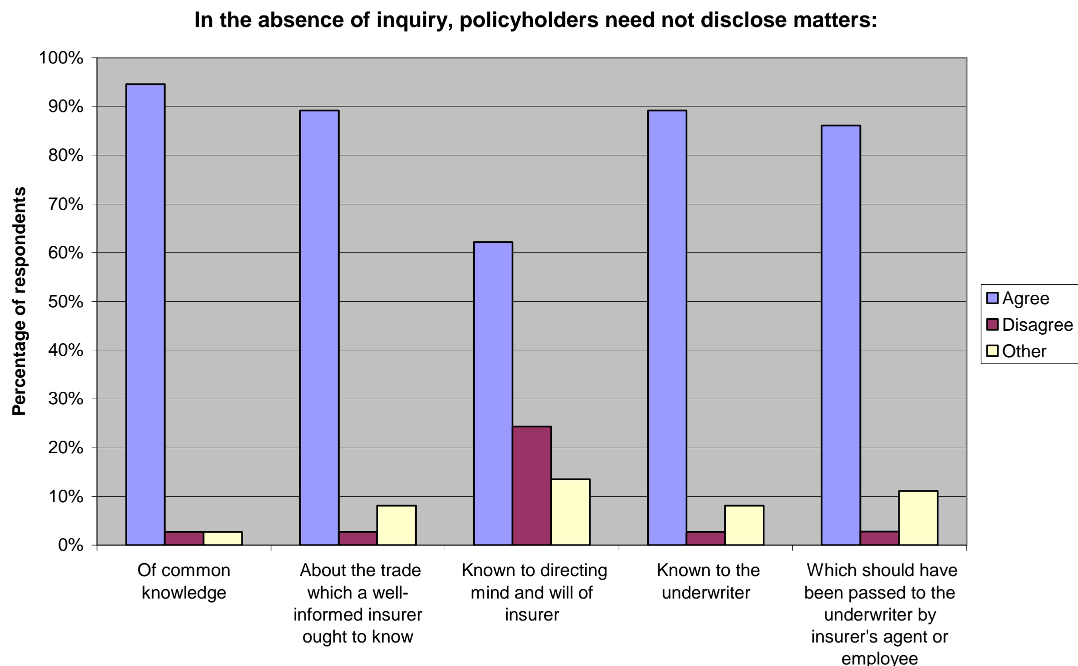
(1) Matters of common knowledge;

(2) Information relating to the practices and risks of the trade which a generally well-informed insurer writing that particular class of business ought to know;

(3) Information which the insurer knows. We proposed that this would be aligned with our proposals for policyholder knowledge, such that the organisation knows a matter which is known to its directing mind and will or to the person making the underwriting decision;

(4) Information held by the insurer's agent or employee which ought to have been communicated to the person making the underwriting decision.

We proposed including these propositions in the legislation. Strong agreement was received for most elements, although there was a lower level of support for including the knowledge of the directing mind and will of the insurer.



Matters of common knowledge

4.37 Of 37 responses to these propositions, 35 (95%) agreed that in the absence of inquiry policyholders need not disclose matters of common knowledge. A&O said that this rule "offers an important protection for policyholders". Several consultees asked for clarification as to what would be considered common knowledge. On the other hand, Keoghs responded that "there is a significant amount of case law on the point". Direct Line Group argued that the definition of common knowledge should "exclude any knowledge specific to the risk or area".

Practices and risks of the trade

4.38 33 respondents (89%) agreed that policyholders need not disclose information concerning practices and risks of the trade which a generally well-informed insurer writing that particular class of business ought to know. Only a few made comments. RSA and the ABI said that this information should be limited to generally accepted standard practices and standard risks relating to the trade. Chartis also felt that the standard should be that of a reasonable insurer rather than one which is well-informed. Finally, Catlin and the ABI argued that this rule could make it harder for a new insurer to enter mature markets.

Information which the insurer knows

4.39 33 respondents (89%) agreed that information known to the underwriter of the risk should be deemed to be known by the insurer. Support dropped to 23 respondents (62%), however, for deeming the knowledge of the directing mind and will of the company to be known to the insurer.

4.40 Few consultees commented on imputing the underwriter's knowledge to the organisation and the proposition commanded near unanimous support. RPC thought that as the underwriter may change, the disclosure duty "could change from renewal to renewal based on staffing changes at the insurer". The only consultee to expressly disagree argued that insureds should always indicate if relevant information is to be found in a previous presentation or other source, regardless of what the underwriter knows.

4.41 Many comments were received concerning information known to the directing mind and will of the company. A number of consultees said that this proposition went "too far", with the Forum of Insurance Lawyers (FOIL) saying that it placed "too much responsibility upon an insurer". These consultees said that the boards of insurers were not involved in individual underwriting decisions, and that requiring underwriters to consult the board for each risk would be "cumbersome and unworkable" (the LMA). Addleshaw Goddard argued that our final proposition concerning information which ought to be conveyed to the underwriter (below at paragraph 4.42) would be sufficient to capture situations in which the board has knowledge which ought to be communicated.

Information which ought to have been communicated to the underwriter

4.42 31 respondents (86%) agreed that policyholders need not disclose information held by the insurer's agent or employee which ought to have been communicated to the person making the underwriting decision. Professor John Birds said that this proposition "would provide helpful clarity". The IUA agreed, saying that "the insured should not be penalised for a failure of the employee or third party acting as agent for the insurer".

4.43 Chartis and RPC argued that including all employees would be too wide an obligation and that determining what "ought" to be communicated would be difficult. CAP and AXA commented that implementing systems to allow for such communication would be expensive and onerous.

PART 5
REMEDIES

PROPORTIONATE REMEDIES AS A DEFAULT REGIME

5.1 At present, the only remedy in the Marine Insurance Act 1906 applicable to disclosure failures is avoidance of the contract. In the Consultation Paper we proposed that, where the policyholder's conduct is not dishonest, proportionate remedies should be the default regime for non-disclosure and misrepresentation in business insurance. Proportionate remedies reflect what the insurer would have done if the policyholder had fulfilled its duties. Consultees strongly supported this proposal. Of 44 respondents to this question, 32 (73%) agreed.

5.2 Only four consultees (9%) disagreed with the proposal, but eight (18%) were classed as "other". Strong support was received from policyholder groups, brokers and lawyers. Although insurers represented three of the four consultees who disagreed outright with the proposal, a majority of insurers overall supported the reform.

Agreement

5.3 Many consultees warmly welcomed our proposal as a fairer remedy, with avoidance at various times called "an unfair bludgeon" (Bar Council), "draconian" (BILA), and an "all or nothing approach" (Allen & Overy and the Judges of the Court of Session). Royal & Sun Alliance Insurance (RSA) reflected the general mood of the responses in their view that avoidance "does not reflect what RSA considers to be reasonable business practice in the modern age". Several consultees also cited the use of proportionate remedies by the Financial Ombudsman Service (FOS) and European civil law systems. Philippe Chennaux, a risk and insurance consultant based in Belgium, reported that they had "created few problems in the last 40 years or so".

5.4 The Chartered Insurance Institute (CII) offered clear support for our proposal:

> We accept that remedies can be complex in situations where the insurance is bespoke or the risk characteristics are unique, and assessing what the insurer would have done had they been in possession of the information might be difficult. Nevertheless, proposing a range of remedies short of avoidance is the right approach… .

Disagreement

5.5 Four consultees disagreed with proportionate remedies: the Forum of Insurance Lawyers (FOIL), Swiss Re, Catlin and the Lloyd's Market Association (LMA). Four themes emerged from the responses:

(1) First, it was felt that limiting insurers' automatic entitlement to avoidance of the contract to dishonest conduct was overly restrictive as dishonesty is too hard to prove. We consider the definition of dishonesty below at paragraph 5.36.

(2) Secondly, it was said that proportionate remedies would increase uncertainty and litigation, or at the least would not bring clarity to the law but merely shift litigation to focus on the insurer's hypothetical response to the policyholder's conduct.

(3) Thirdly, these consultees thought that proportionate remedies would undermine a policyholder's incentive to make proper disclosure.

(4) Finally, some argued that in practice insurers already negotiate fair settlements regardless of the law and as such there is no need for reform.

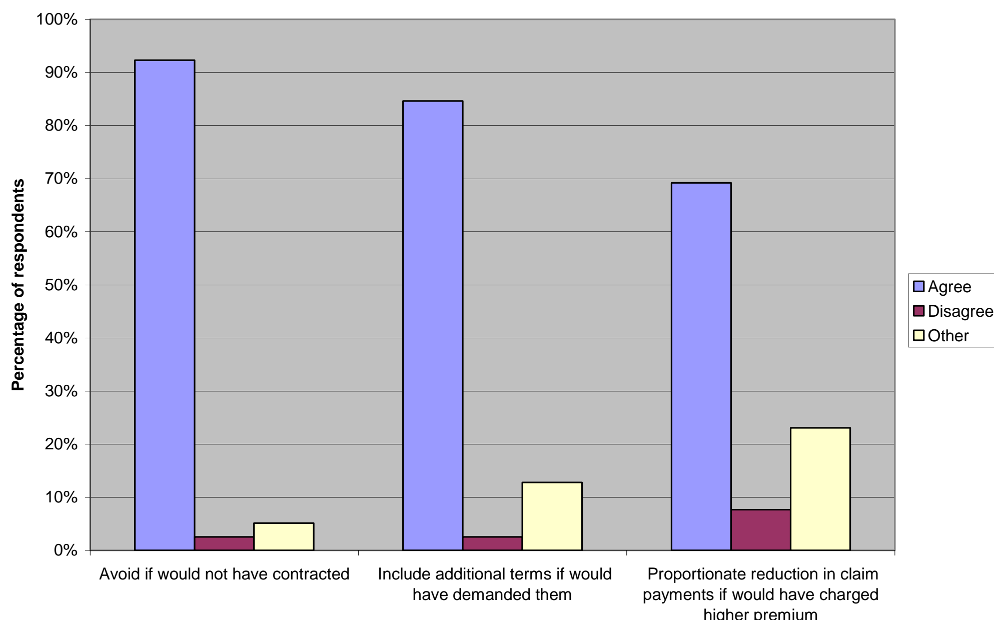
SPECIFIC PROPORTIONATE REMEDIES

5.6 We proposed that proportionate remedies would focus on the contract that the insurer would have entered into with the policyholder if the policyholder had fully complied with its duty of disclosure. We then set out the specific proportionate remedies which would be available to an insurer in a range of scenarios:

(1) If the insurer would not have entered into the insurance contract at all, the insurer may avoid the contract; or

(2) If the insurer would have entered into the contract on different terms (excluding the premium), the contract is to be treated as if it included those terms; and

(3) If the insurer would have charged a higher premium, the insurer may reduce proportionately the amount to be paid on a claim.



Where the insurer would not have entered into the contract at all

5.7 We asked consultees whether the insurer should be entitled to avoid the insurance contract where it would not have entered into the contract at all had proper disclosure been made. There was overwhelming support for this proposition, with 36 of 39 respondents (92%) agreeing. Only one consultee disagreed with this proposal.

5.8 RSA agreed that avoidance was appropriate in this situation as "it properly reflects the legitimate expectations of both parties to the insurance contract at the time of entering into that insurance contract". The Faculty of Advocates commented further that in such a situation, "there can have been no real element of consensus – even if the failure to disclose was not in bad faith".

5.9 Airmic reported that its members were "willing to accept that the insurer may avoid the contract", but only if "the insurer is able to clearly show that it would not have entered into the contract". A number of other consultees also commented that the burden of proof should rest with the insurer. Mactavish went further, suggesting that there should be "relevance between the claim and the material fact(s) concerned".

5.10 The only consultee to disagree that avoidance would be proportionate did not provide further explanation.

Where the insurer would have entered into the contract on different terms

5.11 We proposed that where an insurer would have insisted on the inclusion of certain terms (excluding premium) in the contract had proper disclosure been made, the contract should be treated as if it included those terms. There was strong support for this proposal, with 33 of 39 respondents (85%) in agreement. Only one consultee expressly disagreed with this proposal.

5.12 The Faculty of Advocates noted our proposal "would reflect the reality of what would have happened, had there been proper disclosure". The London & International Insurance Brokers' Association (LIIBA) reported that there was "broad support" for our reform and Airmic said that their members were "on balance in favour of this suggestion".

5.13 Many consultees made submissions relating to the details of the proposal. Airmic and Philippe Chennaux raised the issue of whether any procedural or substantive limits should be placed on the terms an insurer can impose. Airmic suggested that there should be "safeguards in place to protect the policyholder against unfair additional terms", while Philippe Chennaux said that an imposed term should not render the contract void. On the other hand, Chartis pointed out that while some additional terms could result in a claim going unpaid, the proposal would still benefit policyholders by "preserving the insurance cover for other claims".

5.14 Two consultees, Browne Jacobson and FOIL, argued that our proposal could produce stalemate if the policyholder asserts that it would have complied with any additional term (eg a warranty) and as such its claim should remain valid.

5.15 Some consultees pointed to difficulties in establishing how an insurer would have acted if proper disclosure had been made. Claims Against Professionals (CAP) said:

> The inclusion of certain policy terms are subject to several factors, including contemporaneous factors which may change over time. Proving which terms would or would not have been inserted into a particular policy is likely to lead to disputes. Whilst underwriting manuals are in place, commercial reasons may lead to identical risks for different policyholders being written on different terms.

5.16 Consultees pointed to the difficulties of applying proportionate remedies in specialist or complex insurance markets. The International Underwriting Association (IUA) explained:

> …wholesale risks coming into London are often noncommoditised and not considered consumable for normal underwriting in national markets. They are often large and complex in nature, requiring a bespoke policy.

5.17 We consider the ability of the contracting parties to opt out of the proportionate remedies regime below at paragraph 5.51 and following.

Where the insurer would have charged a higher premium

5.18 We proposed that an insurer should be entitled to reduce the sums paid in respect of claims under the policy in proportion to the additional premium it would have charged had the policyholder made a proper presentation of the risk. There was good support for this proposal. Of 39 respondents, 27 (69%) agreed.

5.19 Several consultees argued that a policyholder should be entitled to elect to pay the additional premium in order to protect their claim from being subject to a proportionate reduction. They thought that a proportionate reduction in claim payments was unfair for policyholders when the additional premium might be small compared to the quantum of the claim. The Faculty of Advocates, agreeing with the proposal, argued the converse:

> The possible alternative, of enabling the insurer to recover what would have been the higher premium but to remain on risk, does not seem to us an equitable outcome.

Mactavish agreed, commenting that the "simple retrospective charging of the additional premium only where non-disclosure is discovered is insufficient disincentive [against making a non-disclosure or misrepresentation]".

5.20 Several consultees asked for clarification as to how proportionate remedies will operate in the context of liability policies, particularly motor insurance and employers' liability insurance.

5.21 Those consultees who thought that it would be too difficult to prove that an insurer would have required additional terms made similar comments about increased premiums.

Other matters

More than one remedy

5.22 The IUA and the Association of British Insurers (ABI) gave related comments that insurers may often have been willing to contract on several bases, and that questions about premium levels and additional terms should not be considered in isolation from each other. The IUA said:

> Contract negotiations are not conducted in isolation and changes to terms affect limits and pricing. As such, it needs to be made clear that insurers may need recourse to one or more remedies rather than one or the other.

Capacity limits in group life insurance

5.23 GRiD and Zurich raised a concern about the applicability of proportionate remedies to group life insurance schemes which place strict limits (known as capacity) on the amount of risk they will underwrite in a single geographic area. These consultees thought that proportionate remedies may not work where the policyholder did not fully disclose, or misrepresented, the location of its employees.

5.24 The particular concern is that an insurer who still had capacity in an area at the time of the inception of the policy will not be able to show that it would have acted differently with respect to that policyholder had it known the truth. Instead, the insurer would have refused later risks in order to avoid breaching its capacity. The policyholder's failure causes the insurer to breach its geographical limits on risk, but the insurer will not have a remedy because it would only have acted differently later. The ABI also made this point more generally where the insurer would have taken a different approach to later risks.

REINSURANCE

5.25 In the Consultation Paper, we proposed that reinsurance would not be treated separately. Thus proportionate remedies would apply, subject to the parties agreeing to opt out of the rules. We said that it should be for the parties to work out the details of how proportionate remedies would apply to these contracts and asked whether consultees agreed that the matter could be left to freedom of contract between insurers and reinsurers. Consultees strongly concurred. Of 34 respondents to this question, 29 (85%) agreed.

5.26 Consultees reported that reinsurance is a sophisticated and specialised market in which the parties are able to negotiate suitable arrangements. BILA commented:

> The wide variety of forms which reinsurance contracts may assume and the even wider variety of specific provisions that they may contain would almost certainly make legislation designed to regulate such matters very difficult to draft and quite likely as difficult to apply.

Many consultees thought it unlikely that proportionate remedies would be problematic where reinsurance is written "back-to-back" with the underlying policy.

5.27 Some consultees misconstrued our proposal as entailing separate rules for reinsurance contracts and argued against such an outcome. This is not the case: we are proposing a single default regime of proportionate remedies applying to both insurance and reinsurance contracts, with the freedom for parties to contract on an alternative basis if they desire. No consultee advocated special legislation for reinsurance contracts.

CANCELLATION RIGHTS

5.28 We considered that in principle, policyholders and insurers should be able to cancel contracts to which a proportionate remedy (other than avoidance) has been applied. The resulting contract may no longer achieve the purposes of either party. We asked consultees whether this right should be provided in legislation, entitling both parties to cancel the policy on reasonable notice. 25 of the 37 (68%) respondents agreed that insurers should have a right to cancel for the future. Ten consultees (27%) expressly disagreed, however. 29 of 36 consultees (81%) agreed that policyholders should also have a right to cancel.

Statute or contract?

5.29 While a majority of consultees agreed with the principle that cancellation rights should exist, many commented that such matters are already frequently dealt with by the terms of the policy. The Investment & Life Assurance Group (ILAG) was typical of these respondents:

> In practice we question whether a statute is necessary to deal with this as there are existing industry practices and contract terms.

Similarly, Airmic replied that "cancellation rights already exist and do not need to be further explained or qualified as part of these proposed reforms".

5.30 A significant number of respondents disagreed with the proposal. Objections came from insurers and lawyers as well as brokers. Swiss Re said that cancellation rights should be agreed by the parties at the outset of the contract as it will "depend upon the circumstances if cancellation is appropriate". Likewise, a confidential respondent pointed out that some policies are by their nature not intended to be cancellable. Several consultees made the point that an insurer entitled to apply a proportionate remedy has already been put in the position in which it would have been had the non-disclosure or misrepresentation not been made. Addleshaw Goddard commented that granting a right to cancel "would give insurers an additional remedy".

5.31 Even some respondents who agreed with statutory cancellation rights commented that the issue would usually be dealt with by the contract. After expressing agreement with a statutory right, Direct Line Group said that "in any event, policies usually contain provision for cancellation".

Cancellation by policyholder

5.32 Greater support was received for a right for policyholders to cancel a policy to which a proportionate remedy is applicable. Consultees said that such a right would be fair. For instance, Addleshaw Goddard said:

> It seems fair that, once the claim has been dealt with, the policyholder is not locked into a bargain it did not actually negotiate or agree to.

Berrymans Lace Mawer (BLM) thought a right to cancel appropriate as the policyholder "does not stand to receive the level of cover expected on the terms contracted for".

5.33 Several consultees raised the question of the treatment of premiums if the policyholder elects to cancel. The ABI, RSA and Faculty of Advocates all submitted that the policyholder should not be entitled to any refund of premiums for the remainder of the policy period.

5.34 Seven consultees asserted that, as with insurers, any right of cancellation should be given by the policy and not by statute.

DISHONEST CONDUCT

5.35 Where the policyholder is shown to have acted dishonestly in presenting the risk, we proposed that avoidance should still apply. Accordingly, we consulted on the concept of dishonesty and how this should be defined. We also sought consultees' opinion as to the consequences which should follow where dishonesty is proved.

Statutory definition

5.36 We asked consultees whether legislation should provide a specific definition of dishonest pre-contractual conduct or whether it should instead refer to the common law concept of fraudulent conduct. We proposed a statutory concept of "deliberate or reckless" non-disclosure or misrepresentation.

5.37 Consultees were almost evenly split between these two options. Of 36 respondents, 16 (44%) agreed with a statutory definition, while 15 (42%) favoured leaving the matter to the courts and the common law.

Agreement

5.38 A number of reasons were advanced in support of a statutory definition. The difficulties in proving fraud were cited by several respondents. RSA said: "we believe that evidential burden in the judicially-determined test of fraud is too high". Philippe Chennaux called proving fraud "an uphill task". ILAG reported that their industry had "found it useful to develop and agree specific definitions" of fraud, while the IUA thought that a statutory test "would be helpful".

5.39 The statutory definition of dishonest conduct present in the Consumer Insurance (Disclosure and Representations) Act 2012 ("the 2012 Act") was mentioned by several consultees, who saw benefits in consistency between business and consumer insurance in this respect. Direct Line Group and RSA reported that they saw no need to differentiate between consumers and businesses in respect of pre-contract fraud.

5.40 Finally, Addleshaw Goddard argued that identifying dishonesty with deliberate or reckless behaviour would catch conduct not amounting to fraud but which should nevertheless be discouraged.

Disagreement

5.41 Consultees who favoured following the common law argued that fraud was an established concept which the courts are best placed to apply. BLM, for instance, said:

> The courts have sufficient experience to deal with the issue and there is sufficient case law available as a guide.

5.42 The British Insurance Brokers' Association (BIBA) argued that a statutory definition could make the law "very inflexible". Similarly, Reynolds Porter Chamberlain (RPC) said that "the courts are best place to implement equitable and adaptable rules".

5.43 K&L Gates argued that the difficulties in proving fraud would make insurers “think very carefully” before alleging pre-contract dishonesty.

Definition of deliberate or reckless conduct

5.44 We proposed that if pre-contract dishonest conduct is to be defined in statute, it should encompass behaviour where the proposer:

(1) had actual knowledge of the relevant facts (or shut its eyes to the relevant facts), and;

(2) (in the case of omissions) knew that the facts were relevant to the insurer, or did not care whether or not they were relevant to the insurer;

and failed to disclose the information to the insurer.

5.45 Strong support was received for this definition. 72% of consultees agreed with the first part of this test and 70% agreed with the second part.

5.46 Few comments were received about the definition, but those consultees who did comment made a variety of suggestions. ILAG said that they would prefer the definition to be more closely aligned with the definition in the 2012 Act. Swiss Re and CAP argued that the definition ought to extend to knowledge which the proposer negligently failed to acquire. Catlin said that the test should ask whether the proposer thought that information was *likely* to be relevant to the insurer. RSA and the ABI felt that the burden should fall on policyholders to show that a non-disclosure or misrepresentation was not dishonest.

Consequences of dishonest conduct

5.47 We proposed that where the proposer has acted dishonestly in presenting the risk the insurer should be entitled to:

(1) avoid the policy and refuse all claims; and

(2) keep any premium paid.

5.48 Of 38 responses on avoidance, 34 (90%) were supportive. No consultees who disagreed made comments to explain their position.

5.49 A lower level of support was present for retention of the premium. Of 37 respondents, 27 (73%) agreed. Professor John Birds commented that retention of premium by the insurer was “probably the right approach, to compensate the insurer for its costs etc and as a deterrent”. RSA agreed that retention would “act as a further disincentive to policyholders”. Direct Line Group agreed with retention and suggested that insurers should further be entitled “to re-coup any costs/claims or expenses that the Insurer has paid or incurred”.

5.50 Seven consultees did not agree that an insurer should be entitled to retain the premium. Allen & Overy (A&O) questioned "why the insurer should be entitled to the windfall of the premium when it is no longer to bear any risk". The LMA commented that retention "would be incongruous - if the policy is avoided, the premium should be returned". Swiss Re argued that returning the premium with a deduction for the "insurers' reasonable administration costs" would provide a "penal element to prevent abuse".

CONTRACTING OUT

Freedom of contract

5.51 Given that we thought that proportionate remedies should only be a default regime, we asked whether the parties to a business insurance contract should be entitled to contract out of that regime. Of 41 responses received, 23 consultees (56%) agreed with allowing contracting out. Eleven consultees (27%) expressly disagreed.

Agreement

5.52 Many consultees agreed that freedom of contract in business insurance should be maintained. The Judges of the Court of Session commented:

> Freedom of contract between business enterprises is a fundamental tenet of commercial law.

NFU Mutual also thought that freedom of contract should be preserved "given that the two parties are both corporate entities". Support for freedom of contract was received from the risk mangers' association, Airmic, as well as from the ABI and IUA.

5.53 Direct Line Group also agreed with contracting out and doubted that it would become prevalent in practice. Chartis concurred, saying that they would expect to contract out only:

> …in very limited circumstances in very specialist risks where the balance of knowledge is heavily biased in favour of the policyholder and proportionate remedies aren't considered appropriate.

Keoghs pointed out that some businesses would consent to contracting out "in order to obtain cheaper insurance".

Disagreement and concerns

5.54 Many consultees argued that allowing the parties to contract out of proportionate remedies would undermine our reforms. The Faculty of Advocates expressed concern that contracting out "might readily become the industry standard". BIBA thought that there was no true freedom of contract between businesses and insurers due to their "unequal bargaining position[s]". A broker said that contracting out would be "non-negotiable" for some buyers. K&L Gates commented:

> In many cases policy terms are imposed on business policyholders through their lack of understanding or for commercial reasons.

5.55 The Bar Council and BILA argued that while large businesses could be allowed to contract out, insurers should be prevented from contracting out of proportionate remedies when dealing with small and medium sized businesses.

Requirements for contracting out

5.56 We proposed that where the parties contract out of proportionate remedies, these terms are only effective if written in clear, unambiguous language and specifically brought to the attention of the other party before the contract is formed. Of 36 respondents, 23 (64%) agreed with this formulation.

5.57 No comments were received about the requirements of clear and unambiguous language. Only one consultee argued that there should be no requirements of form at all for contracting out provisions, asserting that this should be governed by "the usual principles of contract law" alone (CAP).

5.58 The remaining comments concerned the proposed requirement that the term be specifically brought to the attention of the other party. Many consultees thought this inappropriate for business insurance. Two principal arguments were advanced, firstly that businesses need "less protection than consumers" (AXA Corporate Solutions Assurance (AXA)) and secondly, that businesses have "ready access to professional advice which negates the need for the insurer to raise particular items" (IUA). The IUA further noted that placing a requirement on insurers to draw the insured's attention to terms would be inappropriate as "the insurer rarely has a direct relationship with the policyholder as the contract is intermediated by a broker".

5.59 On the other hand, brokers and lawyers were strongly in favour of the requirements. Some insurers were also content with the requirements. RSA, for instance, agreed saying:

> This will provide the requisite safeguard to ensure that policyholders (and their agents) are made aware of any term that changes the default legal regime.

PART 6
GOOD FAITH

GOOD FAITH AS AN INTERPRETATIVE PRINCIPLE

6.1 In the Consultation Paper, we proposed that legislation would continue to recognise that insurance contracts are contracts of good faith, but that good faith would no longer provide either party with an independent cause of action. There was strong support for this proposal, with 71% of consultees supporting it. Of the 38 respondents, only 3 (8%) expressly disagreed, though 8 respondents (21%) were classed as “other”.

6.2 Support was received from the Association of British Insurers (ABI), International Underwriting Association (IUA), Law Society of Scotland, Bar Council and Faculty of Advocates, amongst others. Royal & Sun Alliance Insurance (RSA) commented:

> We believe that, if implemented, the proposals set out in this Consultation Paper will provide insurers with sufficient rights and remedies against a defaulting party and render unnecessary a right on the part of either party… [to] avoid an insurance contract (a right that, in almost all cases, would be unlikely to ever be invoked by an insured) where good faith is not observed.

6.3 The Faculty of Advocates provided a reasoned argument in favour of the continuance of good faith as an interpretative principle:

> We believe that this concept should continue to inform the approach of the courts in this field. The further advantage to retaining this as an interpretative principle is that resort may continue to be had to the substantial and well developed jurisprudence on the subject.

6.4 Direct Line Group, Swiss Re and Claims Against Professionals (CAP) argued that good faith should continue to provide an insurer with remedies. Professor Howard Bennett provided detailed comments on the implications of removing good faith as a mutual cause of action but agreed with removing avoidance as the remedy for breach.

6.5 One consultee suggested that the duty of good faith should be removed from legislation altogether, commenting that:

> …the regime would function perfectly well if the duty of good faith was abolished altogether with the duty of disclosure its only vestige. (Heather Thomas)

Professor John Birds also questioned “whether any statutory reference [to good faith] is actually needed” in addition to the specific duty of disclosure.

GOOD FAITH OR UTMOST GOOD FAITH?

6.6 Finally, we asked consultees whether legislation should refer to insurance contracts as contracts of the “utmost good faith” or simply “good faith”. Consultees were fairly evenly split on this question. Of 36 respondents, 16 (44%) favoured “utmost good faith”, while 20 (56%) preferred simply “good faith”.

Is there a difference?

6.7 Consultees expressed contrary views on whether there is a difference between the two phrases. The IUA, RSA, AXA Corporate Solutions Assurance (AXA) and Marsh all thought that they are interchangeable. On the other hand, the ABI, along with the Judges of the Court of Session and NFU Mutual, felt that “utmost” has a role to play in emphasising the importance of the duty to the parties. Professor Howard Bennett agreed that “utmost” might fulfil this role, and argued that “utmost” helps to distinguish insurance law from general commercial law, where parties are prohibited from acting in bad faith.

Is change needed?

6.8 Consultees were also split on whether there was a need to change the law. The IUA, though believing the two phrases to be interchangeable, thought that this showed a lack of compelling argument for change. Swiss Re and Direct Line Group responded that there was no argument to change the current position. On the policyholder side, Airmic also thought that “utmost good faith” should continue though they were unsure how it differed from “good faith”.

6.9 The Lloyd's Market Association (LMA) were content with moving to simple “good faith”. Some consultees did advance positive arguments in favour of a change. Allen & Overy (A&O) reported that “utmost good faith has become overloaded with history which needs to be shed in a more electronically connected world”. K&L Gates and RSA both commented that good faith would be easier to understand, and the British Insurance Brokers' Association (BIBA) said that “the difference between the two is not understood by most clients or insurance personnel”.

APPENDIX
LIST OF CONSULTEES

Addleshaw Goddard LLP
Airmic
Allen & Overy LLP (A&O)
Association of British Insurers (ABI)
AXA Corporate Solutions Assurance, UK Branch (AXA)
The Bar Council
Professor Howard Bennett
Berrymans Lace Mawer LLP (BLM)
Professor John Birds
British Insurance Brokers' Association (BIBA)
British Insurance Law Association (BILA)
British Property Federation
Browne Jacobson LLP
Catlin Underwriting Agencies UK Ltd, Catlin Insurance Company (UK) Ltd
Chartered Insurance Institute (CII)
Chartis Europe Limited
Mr Philippe Chennaux
Claims Against Professionals (CAP)
Direct Line Group
Faculty of Advocates
Financial Ombudsman Service (FOS)
Forum of Insurance Lawyers (FOIL)
Mr Steve Goodacre
GRiD
Mr John Habergham, Myton Law Ltd
Mr David Hunter
International Underwriting Association (IUA)
Investment & Life Assurance Group (ILAG)
Judges of the Court of Session
K&L Gates LLP
Keoghs LLP
Law Society of Scotland
Mr Geoffrey H. Lloyd
Lloyd's Market Association (LMA)
London & International Insurance Brokers' Association (LIIBA)
Mactavish
Marsh Limited
Munich Re UK Life Branch
NFU Mutual Insurance Society Ltd
Mr Peter Patient
Mr John Potter
Reynolds Porter Chamberlain LLP (RPC)
Royal & Sun Alliance Insurance plc (RSA)
RWA Group
Swiss Re Europe S.A., UK branch
Ms Ratchuda Thoieam
Ms Heather Thomas
Zurich Insurance Group

We received two responses in confidence from broking firms.