



**Law
Commission**
Reforming the law



Scottish Law Commission
promoting law reform

**Insurance Contract Law: Business Disclosure;
Warranties; Insurers' Remedies for Fraudulent Claims;
and Late Payment**

Executive Summary

Law Com No 353 / Scot Law Com No 238 (Summary)

July 2014

PART 1

INTRODUCTION

- 1.1 Since 2006 the Law Commission and Scottish Law Commission have conducted a joint project to reform UK insurance contract law.
- 1.2 The review has been carried out in stages. Our first report and draft Bill focused on the consumer's duty of disclosure.¹ The Bill was passed by Parliament using the special procedure for non-controversial Law Commission Bills, and became the Consumer Insurance (Disclosure and Representations) Act 2012 (CIDRA).
- 1.3 This second Report and draft Bill look at four further issues:
 - (1) the duty on a business policyholder to give information to the insurer before taking out insurance (referred to as "fair presentation");
 - (2) insurance warranties;
 - (3) the insurer's remedies for fraudulent claims; and
 - (4) damages for late payment of claims.

CONSULTATION

- 1.4 Our recommendations are the result of detailed consultation over many years. We sought initial views through issues papers and then made formal proposals in three consultation papers:
 - (1) In July 2007, our first consultation paper set out initial proposals for reforming the law on disclosure and warranties (CP1).²
 - (2) In December 2011 our second consultation paper covered damages for late payment of claims and remedies for fraudulent claims (CP2).³
 - (3) In June 2012 our third consultation paper returned to the duty of disclosure in business insurance, and on insurance warranties in all types of contract (CP3).⁴

¹ Consumer Insurance Law: Pre-Contract Disclosure and Misrepresentation (December 2009) Cm 7758, Law Commission No 319; Scottish Law Commission No 219. <http://lawcommission.justice.gov.uk/areas/consumer-insurance.htm> and http://www.scotlawcom.gov.uk/index.php/download_file/view/268/107/.

² Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured (July 2007) Law Commission Consultation Paper No 182; Scottish Law Commission Discussion Paper No 134. <http://lawcommission.justice.gov.uk/consultations/misrep-breach-warranty.hm> and http://www.scotlawcom.gov.uk/index.php/download_file/view/123/107/.

³ Insurance Contract Law: Post Contract Duties and Other Issues (December 2011) Law Commission Consultation Paper No 201; Scottish Law Commission Discussion Paper No 152. http://lawcommission.justice.gov.uk/consultations/post_contract_duties.htm and http://www.scotlawcom.gov.uk/index.php/download_file/view/947/107/.

- 1.5 We also conducted consultation exercises on draft clauses from the Bill, published in January and February 2014.

A NEW INSURANCE ACT

- 1.6 The Report contains a draft Bill. At the time the Report went to press, HM Treasury were consulting on whether the draft Bill was suitable for the special procedure for uncontroversial Law Commission Bills in the 2014-15 Parliamentary session.
- 1.7 On 17 July 2014, the Government introduced the Insurance Bill into Parliament. It contains the majority of the clauses from our draft Bill. However, it excludes two clauses which were not considered sufficiently uncontroversial. The excluded clauses relate to terms relevant to particular descriptions of the loss,⁵ and to late payment.⁶
- 1.8 Although we are disappointed that these two clauses may not be enacted in this session, we welcome the fact that the rest of the Bill has now been put before Parliament. We will work with industry participants to redraft the excluded clauses, in the hope that they can be enacted when a legislative opportunity arises.
- 1.9 We are pleased that the Insurance Bill also provides an opportunity to correct problems with the Third Parties (Rights against Insurers) Act 2010. The 2010 Act enacts recommendations made by the Law Commissions in our 2001 Report,⁷ and we look forward to the 2010 Act coming into force.

THE CASE FOR REFORM

The changing face of the insurance market

- 1.10 Insurance contract law in the UK is based on principles developed in the eighteenth and nineteenth centuries and codified in the Marine Insurance Act 1906 (the 1906 Act). Although the 1906 Act appears to apply only to marine insurance, most of its principles have been applied to non-marine insurance on the basis that it embodies the common law.

⁴ Insurance Contract Law: The Business Insured's Duty of Disclosure and the Law of Warranties (June 2012) Law Commission Consultation Paper No 204; Scottish Law Commission Discussion Paper No 155.
http://lawcommission.justice.gov.uk/consultations/business_disclosure.htm and
http://www.scotlawcom.gov.uk/index.php/download_file/view/1020/107/.

⁵ Clause 11 of the draft Bill.

⁶ Clause 14 of the draft Bill.

⁷ *Third Parties – Rights against Insurers* (Law Com No 272; Scot Law Com No 184)

- 1.11 Insurance has undergone many changes in the last hundred years. A market which was initially based on face-to-face contact and social bonds has developed into one based on systems, procedures and sophisticated data analysis. The types of risks insured have widened and the volume of information available to market participants has grown exponentially. The law has failed to keep pace with these changes. It fails to reflect the diversity of the modern insurance market or the changes in the way people communicate, store and analyse information. Nor does it reflect developments in other areas of commercial contract law.

The law allows unmeritorious refusals

- 1.12 The 1906 Act is insurer-friendly. The principles were developed at a time when the insured knew their business while the insurer did not, and were designed to protect the fledgling insurance industry against exploitation by the insured. Where a policyholder is in breach of an obligation, the law gives wide-ranging opportunities for the insurer to avoid the contract and refuse all claims, or to treat its liability as discharged, even where the remedy seems out of proportion to the wrong done by the policyholder.

The needs of an international marketplace

- 1.13 The 1906 Act became a model for codification, particularly in common law jurisdictions, forming the basis of marine insurance legislation in New Zealand, Australia, Malaysia, India, Hong Kong, Canada and Singapore and influencing the laws of the USA and Japan. However, many of these countries have since reformed their laws to be more insured-friendly.
- 1.14 This leaves the UK out of line with an international marketplace.⁸ If UK law were to lose its international reputation, it could take many years to rebuild.

The problems with codification

- 1.15 Codification has made it difficult for the courts to develop the law to keep pace with commercial changes. Although recent cases have glossed the 1906 Act to accommodate contemporary conditions, the clear words of the 1906 Act continue to exert a strong gravitational pull. The law looks certain on paper, but in practice it is far from it.
- 1.16 In seeking to do justice the courts are forced to reinterpret either the law or the facts, leading to major uncertainties. This encourages parties to seek alternative forums in which to resolve disputes, such as arbitration. This further inhibits the development of the law in any modern and consistent fashion.
- 1.17 Codification is a one-way street. Once the law has been codified, there is no practical way of de-codifying it. Any revision to the 1906 Act requires further primary legislation, which is why this Report focuses on statutory reform.

⁸ In CP2 we refer in particular to the changes in New Zealand, Australia, Canada, Ireland and the USA.

Previous reports

- 1.18 Several previous reports have called for the reform of insurance contract law. The Law Reform Committee recommended reform in 1957.⁹ The Law Commission undertook a review in 1980,¹⁰ concluding that the law was “undoubtedly in need of reform”.¹¹ A major factor in our decision to return to this area was the British Insurance Law Association’ 2002 report, which expressly supported previous work by the Law Commission in this field.¹²

Problems in practice

- 1.19 This Report, unlike our previous report, largely addresses the problems encountered by business insurance buyers. We have received evidence from UK businesses that the current law is adding to insurance disputes.
- 1.20 The Report summarises research from Airmic (the risk managers’ association) and Mactavish (a research and advisory service specialising in insurance and risk). Their research suggests a high (and worrying) number of disputes, particularly about non-disclosure and breach of warranty. For example, a survey of Airmic members in 2010 found that 31% of participants had had issues of non-disclosure raised against them in the last five years, and 5% had been involved in litigation on the issue.
- 1.21 In 2012 and 2013, Mactavish interviewed UK businesses with an annual turnover of £50m or more. Insurance claims were common: around 40% reported making a significant insurance claim within the previous three or four years. However, only a quarter of those claims were resolved to the insured’s general satisfaction. Disputes had arisen in 45% of claims, and these disputes had taken an average of just under 3 years to resolve. The four main grounds for dispute were (in order): policy coverage, quantification of loss, breach of warranty or condition, and non-disclosure.¹³
- 1.22 Clearly, not all disputes are due to difficulties with the law, but some are. We think that defects with the law exacerbate these disputes, leading to cost and delays. In their response to CP3, Mactavish summed up the position as follows:

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 the scope for dispute at the placement stage.

⁹ Fifth Report of the Law Reform Committee (1957) Cmnd 62.

¹⁰ Insurance law: Non-disclosure and Breach of Warranty (1980) Law Com No 104.

¹¹ Above at para 1.21.

¹² BILA, *Insurance Contract Law Reform – Recommendations to the Law Commissions* (2002) at para 4.

¹³ Mactavish summary of recent evidence provided to the Law Commission in January 2014.

The effect of “quality uncertainty”

- 1.23 Insurance buyers find it difficult to assess the quality of insurance when entering into a contract. They cannot tell whether claims will be paid without difficulty, or whether the insurer will exploit loopholes in the law to delay payment and reduce the size of settlements. Unable to assess quality, policyholders tend to buy on price. The emphasis on price then puts greater pressure on insurers to reduce quality.¹⁴
- 1.24 Some aspects of insurance contract law establish a default regime which permits insurers to escape payment for a commercially unmeritorious reason. Many insurers have told us that they do not use the excuses the law offers. However, insurers offering a good quality product remain vulnerable to competitive pressure from others, as long as policyholders do not know how any particular insurer will act in a particular situation.
- 1.25 The reforms are designed to change the default regime so that it meets a basic standard. Outside the consumer market, businesses would still be able to negotiate for less advantageous terms if they wish, but (as we discuss below) such terms should be brought to the buyer’s attention. The aim is to improve the market so that commercial parties can negotiate on price and quality to meet their needs.

THANKS

- 1.26 The two Law Commissions are grateful to the many insurers, brokers, buyers, lawyers and academics who engaged with the review over the years, as we have adapted and refined our proposals.
- 1.27 For business insurance, we recommend new default rules to apply in the absence of agreement to the contrary. It is therefore important that these rules reflect the market’s needs and have widespread support from insurers and buyers.

FUTURE WORK

- 1.28 Three areas which we have considered during this project are not covered by this Report. These areas are: insurable interest; the broker’s liability for premiums; and the requirement for a formal marine policy. We intend to publish a third, and final, report in 2015.

¹⁴ The rise of price comparison websites provides some evidence of this phenomenon.

PART 2

FAIR PRESENTATION

- 2.1 An insured often knows more than the insurer about the risk to be insured. It is therefore important to encourage a full and frank exchange of information before the insurance contract is made. Under the current law, the onus is on the prospective policyholder to disclose information to the insurer. This obligation to “present the risk” enables the UK insurance market to provide insurance for a wide variety of large and specialist risks efficiently and cost-effectively.
- 2.2 We think that this fundamental pre-contract duty is important to the successful operation of the UK insurance market. However, the law which governs the duty no longer works as well as it should. The law pre-dates the information revolution, and does not address the sheer volume of data now available to firms. The law is unclear and difficult to comply with, and the consequences of breaching the duty are harsh.
- 2.3 Good disclosure requires co-operation between both parties: the policyholder knows how the business is run; the insurer knows which facts are relevant to assessing the risk. We think that the law should do more to encourage both sides to work together to exchange information.

THE CURRENT DUTY OF DISCLOSURE

- 2.4 The current law is set out in sections 18 to 20 of the Marine Insurance Act 1906.¹⁵ The central element is section 18, which places an onerous duty on the policyholder to disclose to the insurer “every material circumstance” which the policyholder “knows or ought to know” before concluding a contract. 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”.
- 2.5 This effectively requires the policyholder to look into the mind of a hypothetical prudent insurer and to work out what would influence it, with little additional guidance. The words of section 18 suggest that the insurer may play a passive role, without asking questions or indicating what it wishes to know. As a result, anxious policyholders may burden insurers with huge amounts of unsorted information in an attempt to ensure that nothing is omitted. These “data dumps” are often unhelpful.
- 2.6 The duty of disclosure may not be quite as strict as first appears. The courts have developed the concept of “a fair presentation of the risk”. Case law requires insurers to ask questions where the disclosure they have received to date suggests that there is more they need to know. However, there is a tension between this case law and the words of section 18.

¹⁵ See Chapter 4 of the Report for more detail.

- 2.7 If the policyholder fails to comply with the duty of disclosure, the law provides the insurer with only one remedy: avoidance. This means that the insurer may treat the contract as if it has never been made and refuse all claims. This harsh remedy may over-protect insurers against minor failures.

PROBLEMS

- 2.8 The duty of disclosure has been subject to major criticisms over many years.¹⁶ There is continuing evidence that the duty does not work well. In particular:¹⁷
- (1) The duty is poorly understood – and often appears so onerous that policyholders do not know how to go about complying with it.
 - (2) Medium to large companies in particular do not know how to judge what the company “knows or ought to know”. They may employ several thousand employees in different countries, and do not know whose knowledge is relevant to this test.
 - (3) Although there are exceptions in section 18(3), these are written in archaic language and not well known.
 - (4) The statute appears to allow insurers to play a passive role, without asking questions about relevant issues. This encourages “underwriting at claims stage”, where insurers ask questions only when a claim arises, and then use that information to threaten refusal of the claim.
 - (5) Avoidance is an “all or nothing” remedy, which leads to adversarial disputes. It can be overly harsh, allowing insurers to refuse the whole claim even if, had they known the full information, they would still have accepted the risk but at a slightly higher premium.

SUPPORT FOR REFORM

- 2.9 The great majority of consultees (80%) agreed that there was a need to reform this area of law. Airmic reported that their members were “overwhelmingly in favour of reform”.
- 2.10 Reform was also supported by many insurers and insurance groups, including Direct Line Group, RSA, AXA Corporate Solutions Assurance (AXA), Chartis, NFU Mutual Insurance Society (NFU Mutual), GRiD and the Investment & Life Assurance Group (ILAG). The Association of British Insurers (ABI) told us:

¹⁶ See Law Reform Committee, Fifth Report (1957) Cmnd 62; Law Commission, Insurance Law: Non-disclosure and Breach of Warranty (1980) Law Com No 104; and BILA, *Insurance Contract Law Reform – Recommendations to the Law Commissions* (2002)

¹⁷ The problems with the existing law, and the case for reform, are discussed in Chapter 5 of the Report.

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.

THE RECOMMENDED REFORMS

Building on the current law

- 2.11 At present, sections 18 to 20 of the Marine Insurance Act 1906 set out the law of non-disclosure and misrepresentation in business insurance. We recommend replacing these provisions with a “duty of fair presentation”.¹⁸
- 2.12 Our recommendations build on the current law, as interpreted in case law. Many aspects of the new duty are already part of the law. We are not proposing changes to whom the duty applies to, or when it arises. The duty will continue to include positive elements to disclose material circumstances and negative elements not to misrepresent them. Furthermore, what is “material” will continue to be defined by reference to circumstances which would influence the judgment of a prudent insurer.

A duty for all non-consumer insurance

- 2.13 For consumer insurance, the Consumer Insurance (Disclosure and Representations) Act 2012 (CIDRA) removed the duty on policyholders to volunteer information to the insurer. Instead consumers need only answer the insurer’s questions carefully and honestly.
- 2.14 The duty of fair presentation will apply to all other forms of insurance, which we refer to as non-consumer insurance. This includes insurance for charities, micro-businesses and small or medium enterprises, as well as large risks, marine insurance and reinsurance.
- 2.15 Originally, we had assumed that the burden of disclosure would fall disproportionately on small businesses. In fact, Mactavish reports that the greatest problems are experienced by larger businesses, with a turnover of between £50 million and £5 billion.¹⁹ These are the buyers who we expect to reap the greatest benefits from the reform.

¹⁸ See Chapter 7 of the Report for more detail.

¹⁹ Corporate Risk & Insurance - The Case for Placement Reform. The Mactavish Protocols (2011).

- 2.16 Small businesses buying “off the peg” insurance usually complete proposal forms which ask specific questions, making the disclosure process less onerous. They make smaller claims, which are less likely to be disputed.²⁰ By contrast, large businesses are expected to present the risk, without insurers asking questions or indicating what they wish to know. This is particularly difficult for large multinational businesses.

A more active role for insurers

- 2.17 The current words of section 18 suggest that an insurer may simply sit back and wait for the policyholder to disclose every material circumstance. The courts have suggested that this should be read subject to the doctrine of “waiver”. Where a policyholder gives the insurer sufficient information to put a prudent insurer on notice that it needs to make further enquiries, the insurer should ask appropriate questions. If the insurer fails to do so, it may not seek a remedy against the policyholder for failing to disclose material circumstances which those enquiries would have revealed.²¹
- 2.18 We think this should be seen as central to the duty of disclosure. Good disclosure requires co-operation from both sides. The policyholder knows the facts; the insurer knows which facts are relevant. To provide an effective and efficient process, we think that insurers should see their role as assessing what they are told and asking further questions as appropriate.
- 2.19 We therefore recommend that the disclosure duty should have two limbs. We think that the insured should:
- (1) disclose every material circumstance which the insured knows or ought to know; or
 - (2) failing that, disclose sufficient information to put a prudent insurer on notice that it needs to make further inquiries for the purpose of revealing those circumstances.²²

²⁰ For evidence on the level of disputes experienced by micro-businesses, including the results of a survey by the British Insurance Brokers Association, see CP3 Appendix A.

²¹ See for example, *WISE (Underwriting Agency) Ltd v Grupo Nacional Provincial SA* [2004] EWCA Civ 962, [2004] 2 All ER 613 at [63]. See also Consultation Paper 3 (CP3), Part 5 for a detailed discussion of the case law.

²² See clauses 3(3)(a) and 3(4) of both the draft and the final Bill. Discussed from paragraph 7.21 of the Report.

An end to data dumping and oblique presentations

- 2.20 At present, a policyholder may be able to fulfil its duty of disclosure by sending large quantities of unsorted information on to the insurer, without a summary or signposting. We recommend that this should not constitute a fair presentation of the risk. Instead, policyholders should disclose information in a manner which would be reasonably clear and accessible to a prudent insurer.²³

Clarifying what an insured “knows or ought to know”

- 2.21 Under section 18 of the 1906 Act, an insured must disclose every material circumstance which it knows or ought to know “in the ordinary course of business”. However, neither the statute nor the case law provides much guidance on whose knowledge within the organisation is relevant for these purposes, or what enquiries the insured should carry out before applying for insurance.
- 2.22 Risk managers told us that this issue was of great practical importance, as they need to know how to go about gathering information. As an Airmic guide makes clear, this can be an onerous task, which may involve multiple sources of information and many months’ work.²⁴
- 2.23 We wish to give policyholders greater guidance on how to comply with their duties. The draft Bill therefore defines what a policyholder “knows or ought to know” for the purposes of a fair presentation.²⁵ In broad terms, we recommend that a policyholder should be taken to know what is known to its senior management or to the individuals who participate in the procurement of the insurance. In addition, the insured should carry out a reasonable search of available information, whether by making enquiries of its staff and agents or by other means.

The broker’s knowledge

- 2.24 At present, section 19 of the Marine Insurance Act 1906 appears to place a duty on the insured’s broker to disclose information. However, the effect of a breach of section 19 falls on the insured, not the broker. Effectively, section 19 extends the insured’s duty to disclose information beyond that which the insured knows or ought to know, to include information which the broker knows or ought to know.

²³ See clause 3(3)(b) of both the draft and the final Bill. Discussed from paragraph 7.41 of the Report.

²⁴ Airmic, *Disclosure of Material Facts and Information in Business Insurance* (2011). Discussed in CP3, from para 6.68.

²⁵ See clause 4 of both the draft and the final Bill. Discussed in Chapter 8 of the Report.

- 2.25 Under our recommended reforms, this point is made explicit. The draft Bill does not include a direct equivalent to section 19. Instead, the definition of what an insured “knows” includes information known by an individual broker or other agent who participates in the process of procuring the insured’s insurance. Similarly, the definition of what an insured “ought to know” includes information which would have been revealed by a reasonable search of available information held by others, such as the broker.²⁶
- 2.26 This is subject to an important exception: a policyholder is not taken to know confidential information acquired by the broker through a business relationship with someone other than the insured.²⁷

Examples of material circumstances

- 2.27 To provide policyholders with greater guidance on the type of information which should be disclosed, we recommend an indicative and non-exhaustive list of circumstances which may be material, taken from the case law. The draft Bill lists three examples of circumstances which may be material:²⁸
- (1) special or unusual facts relating to the risk;
 - (2) any particular concerns which led the insured to seek insurance; and
 - (3) anything which those concerned with the class of insurance and field of activity would generally understand as something that should be dealt with in a fair presentation of risks of the type in question.
- 2.28 The most significant example is the third: circumstances which those in the market would generally understand should be covered. We hope that insurers, brokers and policyholders will work together to develop guidance and protocols about what should be disclosed, to put flesh on the bones of this structure.

Clarifying the exceptions

- 2.29 Some exceptions to the duty of disclosure are set out in section 18(3) of the 1906 Act, but these are not well-known or understood. In particular, under section 18(3)(b), policyholders do not have to disclose circumstances “which are known or presumed to be known to the insurer”. An insurer is presumed to know matters of “common notoriety or knowledge” and matters which it ought to know “in the ordinary course of business”.
- 2.30 Like policyholders, insurers may now be very large organisations in which knowledge is spread through multiple people and sites. Information held in an old claims file on a legacy system may not be available to the underwriter making the decision.

²⁶ See clause 4 of both the draft and the final Bill. Discussed in Chapter 9 of the Report.

²⁷ See clause 6(3) of the draft Bill, and clause 4(5) of the final Bill. Discussed from paragraph 9.41 of the Report.

²⁸ See clause 7(4) of both the draft Bill and the final Bill.

- 2.31 We recommend clarification of what an insurer should be taken to know. The test should concentrate on information which is known or available to the underwriter. Information held elsewhere in the organisation should only fall within the exception if it should have been communicated to the underwriter or was readily available to the underwriter. At the same time, insurers should be reasonably competent. They should be expected to know matters of common knowledge or circumstances which that type of insurer would reasonably be expected to know.
- 2.32 We see the exception currently set out in section 18(3)(c) as composed of three categories: what an insurer knows, ought to know and is presumed to know. We recommend that:²⁹
- (1) an insurer only knows something if it is known to the people participating in the underwriting decision;
 - (2) an insurer ought to know something:
 - (a) if it is known to the insurer's employee or agent and ought reasonably to have been passed to the underwriter; or
 - (b) it is held by the insurer and was readily available to the underwriter;
 - (3) an insurer is presumed to know something if it is common knowledge, or it is something which an insurer offering that type of insurance ought to know in the ordinary course of business.

A new system of remedies

- 2.33 The most significant change we recommend is to the remedies. Where the insured's breach of the duty of fair presentation is deliberate or reckless, we think that the insurer should continue to be entitled to avoid the contract and refuse all claims. It need not return any premium paid.
- 2.34 In other cases, however, the insurer should have a more proportionate remedy based on what it would have done had the presentation been fair. For example:
- (1) if the insurer would have accepted the risk but charged a higher premium, it may reduce any claim proportionately;
 - (2) if the insurer would have entered into the contract on different terms (other than premium), it may treat the contract as if it contained those terms;
 - (3) if the insurer would not have entered into the contract at all, it may avoid the contract and refuse all claims, but must return the premium.³⁰

²⁹ See Chapter 10 of the Report and clause 5 of both the draft Bill and the final Bill.

³⁰ See clause 8 and Schedule 1 to both the draft Bill and the final Bill. Discussed in Chapter 11 of the Report.

- 2.35 These remedies have already been introduced for consumer insurance and are familiar to the insurance industry.³¹

Road Traffic Act 1988, section 152(2)

- 2.36 This Act sets out the scheme for compulsory motor insurance. Generally, insurers are required to compensate a third party even if the insured has breached the insurance policy. However, under section 152(2), an insurer may obtain a declaration that it is entitled to avoid the policy for non-disclosure or misrepresentation. This is a small and limited exception, as usually an insurer must still pay the claim under the Motor Insurers' Bureau scheme.
- 2.37 We recommend that for non-consumer motor insurance, an insurer should only be entitled to a declaration under this section if it would be entitled to avoid the policy under the new Act.³²

CONTRACTING OUT

- 2.38 These recommendations are intended to be a default regime. The parties would be free to agree other arrangements. We wish to discourage boiler plate clauses which opt out of the default regime as a matter of routine, particularly in the context of mainstream business insurance. However, in sophisticated markets including the marine insurance market we would expect contracting out to be more widespread.
- 2.39 We do not propose to place any general restrictions on the *extent* to which the regime can be altered by contract. Parties may agree specific provisions about the extent of the duty of fair presentation which we recommend, potentially making it more onerous on the insured. They may agree bespoke provisions determining how far the insured has to go to collect information about its organisation, or increasing the number of people whose knowledge is directly attributed to the insured. The insurer may also wish to provide that any breach of the duty of fair presentation allows it to avoid the contract entirely, rather than giving rise to the recommended regime of proportionate remedies.
- 2.40 On the other hand, we recommend that, wherever an insurer wishes to include a contractual term which puts the insured in a worse position than it would be in under our recommended regime, the insurer should have to satisfy two procedural requirements:³³

- (1) the insurer must take sufficient steps to draw the term to the insured's attention before the contract is entered into; and
- (2) the term must be clear and unambiguous as to its effect.

³¹ Consumer Insurance (Disclosure and Representations) Act 2012.

³² See clause 19(4) of both the draft Bill and the final Bill. Discussed from paragraph 31.5 of the Report.

³³ See clauses 17 and 18 of the draft Bill, and clauses 15 and 16 of the final Bill. Discussed in Chapter 29 of the Report.

2.41 These are referred to in the draft Bill as the “transparency requirements”. They are intended to apply flexibly: for example, more will need to be done to draw a clause to the attention of a small business than to a sophisticated ship owner. Where the insured is represented by a broker it will be sufficient to draw the clause to the attention of the broker.

PART 3

WARRANTIES

- 3.1 An insurance warranty is a promise made by the policyholder to the insurer which, if broken, has harsh consequences for the policyholder.
- 3.2 The general principles of insurance warranty law are founded on the rulings of Lord Mansfield in the eighteenth century. The classic case is *De Hahn v Hartley*.³⁴ There, an insurance policy contained a term to the effect that a ship would leave Liverpool for the West Indies with “50 hands or upwards”. The ship left Liverpool with a crew of only 46, but it picked up another six crew-members in Anglesey, just a few hours into the voyage and before any loss was suffered. The ship was eventually captured and lost off the coast of Africa. The insurer refused to pay the claim on the basis that the term had not been strictly complied with. The court agreed: warranties had to be complied with exactly, and the insurer would be discharged from liability where they were not. It was immaterial that the breach of warranty had been remedied within a few hours and before any loss occurred.
- 3.3 These principles were codified in the Marine Insurance Act 1906. Section 33(3) states that a warranty “must be exactly complied with, whether material to the risk or not”. If not, then “the insurer is discharged from liability from the date of the breach of warranty”. Section 34(2) confirms that once a warranty is breached, the policyholder “cannot avail himself of the defence that the breach has been remedied, and the warranty complied with, before loss”. Technically, the 1906 Act applies only to marine insurance, but the courts have applied these provisions to all insurance contracts.

PROBLEMS WITH THE CURRENT LAW

- 3.4 The law of insurance warranties has been subject to major criticisms over many years. In Consultation Paper 3 (CP3) we identified four problems with it:
 - (1) An insurer may refuse a claim for a trivial mistake which has no bearing on the risk.
 - (2) The insured cannot use the defence that the breach has been remedied.
 - (3) The breach of warranty discharges the insurer from all liability, not just liability for the type of loss in question. For example, a failure to install the right sort of burglar alarm would discharge the insurer from liability for a flood claim.
 - (4) A statement may be converted into a warranty using obscure words that few policyholders understand. For example, if a policyholder signs a statement on a proposal form that their answers form the “basis of the contract”, this can have draconian consequences.

³⁴ (1786) 1 TR 343.

- 3.5 For many years, the courts have attempted to moderate the harshness of the law with creative reasoning. This approach has allowed the courts to do justice in some individual cases and it discourages insurers from taking purely technical points. While this has its advantages, it also introduces complexity and uncertainty into the law.

SUPPORT FOR REFORM

- 3.6 The vast majority of consultees from all sides of the market support reform in this area. In response to CP3, 36 out of 42 respondents (88%) agreed that there was a need to reform the law of warranties as set out in sections 33 and 34 of the 1906 Act. The comments of one consultee (who did not wish to be named) reflected widely held opinions:

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

THE RECOMMENDED REFORMS

- 3.7 We make three recommendations:
- (1) To abolish basis of the contract clauses.
 - (2) To provide that breach of warranty may be remedied.
 - (3) Where terms are designed to reduce the risk of loss of a particular kind (or at a particular time or place) they should not affect losses of a different kind (or at a different time or place).
- 3.8 The first recommendation only affects non-consumer insurance policies. Basis of the contract clauses in consumer insurance contracts have already been abolished by the Consumer Insurance (Disclosure and Representations) Act 2012.
- 3.9 Technically, the other two recommendations affect consumer insurance. However, consumers already have greater protection. Financial Conduct Authority rules prevent an insurer rejecting a consumer claim for breach of warranty “unless the circumstances of the claim are connected to the breach”, and the Financial Ombudsman Service applies this rule. The benefit of our reforms will be felt by business policyholders.

“Basis of the contract” clauses to be of no effect

- 3.10 If a policyholder signs a proposal form which includes a clause stating that the proposal forms the “basis of the contract”, this converts every statement on that form into a warranty. It allows the insurer to avoid paying a claim if any statement on the form is inaccurate, even if the statement is minor and immaterial. Thus a mistake in an address which has no bearing on the risk may in theory be used to refuse a claim.³⁵
- 3.11 Judges have criticised “basis of the contract” clauses for over a century. In 1908, Lord Justice Fletcher Moulton said he wished he could “adequately warn the public against such practices”.³⁶ However, as recently as 2013, the Court of Appeal confirmed that basis of the contract clauses remain valid.³⁷
- 3.12 We recommend that basis of the contract clauses should be of no effect.³⁸ Instead, insurers will be protected in two ways. Where a policyholder makes a material misrepresentation before entering into a contract of insurance, this will be a breach of the duty of fair presentation. If insurers wish to have greater rights to refuse claims, they may still use warranties of past or present fact, but they should be included specifically in the contract.

Breaches of warranty may be remedied

- 3.13 Breach of warranty by a policyholder currently leads to an automatic discharge of the insurer’s liability from that point. We recommend that, instead, the insurer’s liability should be suspended rather than discharged in the event of breach, and that liability should be restored if the breach of warranty is remedied.³⁹ Where the breach is remedied before a loss, the insurer should pay the claim. Where loss occurs, or is attributable to something happening, after a breach but before remedy, the insurer should not be liable for that loss. There was strong support for this proposal: of 42 consultees who responded to the question, 33 (79%) agreed with our proposals.
- 3.14 Several consultees pointed out that some breaches of warranty cannot be remedied in practice. We agree. In these cases, liability should remain suspended, as occurs where a breach could be remedied but has not been.

Terms relevant to particular losses affect only that type of loss

- 3.15 This recommendation focuses on warranties and other terms which are designed to reduce the risk of a particular type of loss, or the risk of loss at a particular time or in a particular place.

³⁵ See, for example, *Dawsons Ltd v Bonnin* [1922] 2 AC 413, 1922 SC (HL) 156.

³⁶ *Joel v Law Union and Crown Insurance Co* [1908] 2 KB 863 at 885.

³⁷ *Genesis Housing Association Ltd v Liberty Syndicate Management Ltd for and on behalf of Liberty Syndicate 4472 at Lloyd’s* [2013] EWCA Civ 1173, [2013] WLR (D) 368.

³⁸ See clause 9 of both the draft Bill and the final Bill. Discussed in Chapter 16 of the Report.

³⁹ See clause 10 of both the draft Bill and the final Bill. Discussed in Chapter 17 of the Report.

- 3.16 We recommend that breach of such a term should only affect the insurer's liability in respect of losses in the same category.⁴⁰ Thus the breach of a warranty to install a burglar alarm would suspend liability for loss caused by an intruder but not for flood loss. Similarly, a failure to employ a night watchman would suspend the insurer's liability for losses at night but not for losses during the day. This proposal is not confined to traditional warranties, and would apply to any contract term designed to reduce particular risks.
- 3.17 Following the consultation by HM Treasury, four consultees objected to clause 11 in the Report's draft Bill, which implements this recommendation. Two stakeholders representing the London market suggested in a joint response that the policy as formulated was not workable. One insurer felt that an attempt to clarify the scope of a warranty or term would serve only to cause ambiguity. An academic research group thought that the clause lacked clarity.
- 3.18 This clause is not included in the Bill currently before Parliament. We will continue to work with industry representatives to encapsulate the policy in a clearer way, with a view to introducing this clause when a legislative opportunity presents itself.

Contracting out

- 3.19 For consumer insurance, we propose a compulsory regime, so that an insurer could not use a contract term to put the consumer in a worse position than they would be in under the draft Bill.⁴¹
- 3.20 In non-consumer insurance, the parties would generally be free to make alternative arrangements in their contracts. We are not preventing insurers from including conditions which are so fundamental that breach by the insured should discharge the insurer from all liability. However, the transparency requirements would apply.⁴² The term must be clear and unambiguous as to its effect and the insurer must take sufficient steps to draw the term to the insured's attention before the contract is entered into.
- 3.21 Parties should not be able to contract out of the prohibition on basis of the contract clauses.⁴³ By this, we mean that the parties should not be able to agree to convert statements into warranties by use of a basis of the contract clause (or any other form of generic wording). On the other hand, the parties *may* agree to include specific warranties relating to the same issues as the statements on the proposal form, provided that they are explicitly set out in the contract.

⁴⁰ See clause 11 of the draft Bill. See also Chapter 18 of the Report.

⁴¹ See clause 16 of the draft Bill and clause 14 of the final Bill. Discussed at paragraph 17.69 and in Chapter 29 of the Report.

⁴² See clauses 17 and 18 of the draft Bill, and clauses 15 and 16 of the final Bill. Discussed from paragraphs 17.70 and 18.52 of the Report.

⁴³ See clauses 17(1) and 17(2)(a) of the draft Bill, and clause 15(1) of the final Bill.

PART 4

INSURERS' REMEDIES FOR FRAUDULENT CLAIMS

- 4.1 Fraudulent insurance claims are a serious and expensive problem. The Association of British Insurers (ABI) reported that insurers uncovered over 118,500 fraudulent claims in 2013, with a total value of £1.3 billion.⁴⁴ Further fraud remains undetected.⁴⁵ Honest policyholders endure increased premiums because of the losses suffered by insurers and the investment in resources to detect it.⁴⁶
- 4.2 Yet insurance fraud is often thought of as an “easy crime”. A recent ABI consumer survey found that 42% of respondents felt that insurance fraud was an easy way to make money quickly, and 27% believed the penalties for fraud were negligible.⁴⁷
- 4.3 It is important for the law to set out clear, robust sanctions to deter policyholders from acting fraudulently. Although insurance fraud is a criminal offence, prosecutions are relatively rare, meaning that the civil law has an important part to play in deterring fraud. It should also grant remedies to insurers which are principled, proportionate and reliable.
- 4.4 However, the current law on the effect of a fraudulent claim is convoluted and confused.⁴⁸ There is tension between the common law rule that the fraudster forfeits the fraudulent claim, and a statutory rule which allows the insurer to avoid the whole contract from the outset if the insured breaches the duty of good faith.

OVERVIEW

- 4.5 We are not recommending a statutory restatement of the law on insurance fraud generally. For example, we do not seek to define fraud in the draft Bill. Instead, we recommend that when an insured commits fraud in relation to a claim, the insurer should:
- (1) have no liability to pay the fraudulent claim; and
 - (2) be entitled to refuse all claims arising after the fraud; but

⁴⁴ ABI, “Insurance cheats feel the heat – value of fraudulent claims uncovered by insurers hits record level” (30 May 2014) <https://www.abi.org.uk/News/News-releases/2014/05/Insurance-cheats-feel-the-heat-value-of-fraudulent-claims-uncovered-by-insurers-hits-record-level>.

⁴⁵ ABI report, *No Hiding Place: Insurance Fraud Exposed* (2012). The ABI estimated £2bn.

⁴⁶ On average, fraud adds an extra £50 on to every insurance premium. See ABI Report (2012), p 3.

⁴⁷ ABI Quarterly Consumer Survey 2012 Q4 (May 2013).

⁴⁸ See Chapter 20 of the Report.

- (3) remain liable for legitimate losses *before* the fraud.⁴⁹
- 4.6 We also recommend special provisions to address fraud committed by a member of a group policy.

SUPPORT FOR REFORM

- 4.7 Support for reform was strong, and concerns were limited. They have been described as “a sensible exercise in distilling and, where obscure, clarifying the uncertain position left by the existing case law.”⁵⁰
- 4.8 The Lloyd’s Market Association (LMA) said:

We support the concept of a clear but fair law on forfeiture as a deterrent to fraud.

- 4.9 Norton Rose LLP thought that our proposal would “provide greater clarity and certainty in relation to remedies against fraud”. RSA also welcomed “statutory confirmation” of the remedy of forfeiture.

THE RECOMMENDED REFORMS

No liability to pay the fraudulent claim

- 4.10 The courts have held that fraudulently exaggerating an insurance claim should result in forfeiture of the claim, including the genuine part of the loss. We recommend setting out in legislation that, where an insured makes a fraudulent claim under an insurance contract, the insurer should have no liability to pay the claim. We also recommend that the insurer should be entitled to recover any payments which have already been made in respect of the claim.⁵¹
- 4.11 What constitutes a fraudulent claim is a matter for the courts to determine in all the circumstances of a particular case.⁵²

⁴⁹ These recommendations are discussed in detail in Chapter 23.

⁵⁰ Simon Rainey QC, “The Law Commission’s Proposals for the Reform of an Insurer’s Remedies for Fraudulent Claims Made under Business Insurance Contracts” given at the 25 April 2013 Symposium on the Law Commissions’ proposals run by the Institute of International Shipping and Trade Law, Swansea University.

⁵¹ See clauses 12(1)(a) and 12(1)(b) of the draft Bill, and clauses 11(1)(a) and 11(1)(b) of the final Bill.

⁵² See from paragraph 22.17 of the Report.

An option to treat the contract as having been terminated at the time of the fraudulent act

- 4.12 Once a policyholder has been fraudulent, we do not think that the insurer should be bound to continue the contractual relationship. We recommend, therefore, that the insurer should be entitled to treat the contract as having been terminated at the point of the fraudulent act – that is, from the behaviour which makes a claim fraudulent.⁵³ This right should be exercisable at the point at which fraud is discovered, whether or not the contract has expired before discovery of the fraud.
- 4.13 If the insurer exercises this right, it will not be liable to pay claims in respect of losses suffered after the fraudulent act. Furthermore, it need not return any premiums which have been paid before the right is exercised. This remedies the uncertainty on this issue in the current case law.

Legitimate losses before the fraudulent act

- 4.14 We recommend that the insurer's remedies for fraudulent claims should not affect previous valid claims. This is the result of our recommendation, discussed below, to remove avoidance as the remedy for breach of good faith under section 17 of the Marine Insurance Act 1906.⁵⁴ However, the draft Bill also provides for this explicitly. This remedies a confusion within the current law.

Fraud by a member of a group insurance scheme

- 4.15 In group schemes, a single policyholder takes out a policy for the benefit of a number of beneficiaries. The classic example is where an employer takes out health or life insurance for the benefit of its employees.
- 4.16 Here the insurer's remedy in the event of a beneficiary making a fraudulent claim is unclear at best. In CP2, we commented that as group members are not policyholders, the normal rules of forfeiture do not appear to apply to them. We thought that the only sanction would be that the member would not receive the fraudulent element of the claim.⁵⁵
- 4.17 We recommend that the group members who make fraudulent claims should be subject to the same penalties as policyholders.⁵⁶ In other words, the insurer's remedies for fraud as set out above should apply in group schemes, except that they should apply against the fraudulent beneficiary rather than the policyholder. This means that only the insurer's liability in respect of the fraudster is affected. Insurers will continue to be liable in respect of claims by non-fraudulent members of the group.

⁵³ See clauses 12(1)(c) and 12(2) of the draft Bill, and clauses 11(1)(c) and 11(2) of the final Bill.

⁵⁴ See clause 15 of the draft Bill and clause 13 of the final Bill. Discussed in Chapter 30 of the Report.

⁵⁵ CP2, para 9.25.

⁵⁶ See clause 13 of the draft Bill, and clause 12 of the final Bill. Discussed from paragraph 23.63 of the Report.

Contracting out

- 4.18 We recommend a mandatory regime where consumers are concerned (including consumers who are members of group schemes).⁵⁷
- 4.19 As in our other areas of reform, parties to a non-consumer insurance contract should be able to modify the remedies available for fraud by the use of express contractual terms. However, these would be subject to the transparency requirements discussed above.

⁵⁷ On group insurance, see clauses 16(2)(b) and 17(4) of the draft Bill, and clauses 14(2)(b) and 15(3) of the final Bill.

PART 5

LATE PAYMENT

- 5.1 Where an insurer has unreasonably refused to pay a claim or paid it only after unreasonable delay, the current law in England and Wales does not provide a remedy for the insured.⁵⁸ Notably, the insured is not entitled to damages for any loss suffered as a result of the insurer's unreasonable actions.
- 5.2 The case of *Sprung v Royal Insurance (UK) Ltd* illustrates the problems.⁵⁹ When Mr Sprung suffered damage to his factory, the insurers failed to pay his claim for four years, by which time he had been forced out of business. The judge at first instance found that, as a result of the insurer's delayed payment, Mr Sprung had suffered further losses of £75,000. The Court of Appeal held, with "undisguised reluctance", that the insurers were not liable for losses of this type.⁶⁰
- 5.3 This differs from the law in Scotland and most major common law jurisdictions, where such damages are available. The legal position in England and Wales is anomalous and out of step with general contractual principles.
- 5.4 We consider that a policyholder should have a remedy where an insurer has acted unreasonably in delaying or refusing payment. We therefore recommend a statutory implied term in every insurance contract that the insurer will pay sums due within a reasonable time. Breach of that term should give rise to contractual remedies, including damages. In Scotland the statutory provision will serve to confirm and clarify the position already established at common law.
- 5.5 We recognise that insurers need a reasonable time to investigate claims, and that the length of time required will depend on factors such as the type of insurance and the complexity of the claim. We also understand that the speed with which a claim can be paid may depend on the insured themselves, and other factors outside the insurer's control. Furthermore, insurers have an obligation to ensure that only valid claims are paid. We therefore recommend that they should not be liable for delays caused by genuine disputes.

THE RECOMMENDED REFORMS

An implied term to pay sums due within a reasonable time

- 5.6 We recommend that it should be an implied term of an insurance contract that insurers will pay sums due within a reasonable time.⁶¹ An insured who suffers loss as a result of breach of that term should be able to recover contractual damages from the insurer.

⁵⁸ See Chapter 25 of the Report.

⁵⁹ *Sprung v Royal Insurance (UK) Ltd* [1999] 1 Lloyd's Rep IR 111.

⁶⁰ Above at p 118.

⁶¹ See clause 14(1) of the draft Bill. The recommendations are discussed in more detail in Chapter 28 of the Report.

Guidance as to “reasonable time”

- 5.7 What is a reasonable time for payment will depend on all the circumstances of the particular case. However, the uncertainty surrounding this issue was a key concern for stakeholders. We therefore recommend that some guidance is provided.⁶²
- 5.8 We think that a reasonable time should always include time to investigate and assess the claim.
- 5.9 We also suggest that the following list of considerations may be relevant in determining a reasonable time for payment in a particular case:
- (1) the type of insurance;
 - (2) the size and complexity of the claim;
 - (3) compliance with any relevant statutory or regulatory rules or guidance; and
 - (4) factors outside the insurer’s control.

A reasonable but wrong refusal

- 5.10 We recommend that insurers should have a defence to a claim for late payment where they incorrectly refuse to pay a claim but can show that they acted reasonably in doing so.⁶³ This protects the ability of insurers to take a robust approach to decision making where they suspect fraud or non-compliance with policy terms or where the precise circumstances of the loss are not clear. Our recommendations are intended to catch bad claims handling practices, not prevent legitimate investigations by insurers.

The normal limitation and prescription rules should apply

- 5.11 In England and Wales, the limitation period for insurance claims will continue to run from the date of the original loss, while we recommend that the period for late payment claims should run from the point at which the obligation to pay within a reasonable time is breached.
- 5.12 In Scotland, the prescriptive period for insurance claims will continue to run from the date of the casualty. For late payment claims it will run from the point at which loss flows to the insured from the insurer’s failure to pay the claim within a reasonable time.⁶⁴

⁶² See clauses 14(2) and (3) of the draft Bill.

⁶³ See clause 14(4) of the draft Bill.

⁶⁴ Discussed from paragraph 28.66 of the Report.

Contracting out

- 5.13 We recommend that the late payment provisions should be mandatory in consumer insurance contracts. This reflects the approach already taken by the Financial Ombudsman Service.
- 5.14 In non-consumer contracts, the provisions would be a default regime. This means that insurers would be entitled to exclude or limit their liability for breach of that term, subject to the normal transparency provisions. However, we recommend that such exclusions should be of no effect where the insurer's breach was deliberate or reckless.⁶⁵

SUPPORT FOR REFORM

- 5.15 The responses to CP2 revealed widespread agreement that the law on damages for late payment in England and Wales should be reformed. Over 80% of respondents to CP2 agreed that insurers should be under a contractual obligation to pay claims within a reasonable time and that breach should trigger a liability to pay damages for any foreseeable losses which result.
- 5.16 The Association of British Insurers (ABI) said:

The ABI accepts that there is a need for reform in this area ... If the insurer has declined a valid claim and has acted unreasonably, we accept that the law should be brought into line with general commercial contractual principles.

- 5.17 The Financial Ombudsman Service (FOS), which has jurisdiction to hear complaints against insurers from consumers and micro-businesses, makes its decisions on fairness rather than strict application of the law.⁶⁶ The FOS told us:

We have already been applying a remedy of damages for late payment for some time and there is also broad acceptance within the industry about the approach we take. However, this approach is inconsistent with the current legal position in the case of *Sprung*.⁶⁷

- 5.18 There was also majority support for reform among insurance companies and insurance trade bodies. Out of the 14 insurers and insurance organisations who responded, 11 agreed that insurers should be under a contractual obligation to pay claims within a reasonable time.

THE CONTRARY ARGUMENTS

- 5.19 A few consultees were concerned that awarding anything more than interest to policyholders who had suffered loss because of an insurer's refusal or delay would expose insurers to unlimited extra costs leading to increased premiums and difficulties with capital requirements.

⁶⁵ See clauses 17(1) and 17(2)(b) of the draft Bill.

⁶⁶ The FOS is discussed in more detail in Chapter 2 of this Report.

⁶⁷ [1999] 1 Lloyd's Rep IR 111.

5.20 In its response to CP2, the International Underwriting Association (IUA) said that:

allowing recourse to unlimited damages would potentially open up the claims process to increased litigation on bad faith grounds, which would be difficult to police and would inevitably drive up legal costs and the costs of insurance. The propensity for a damages award that vastly exceeds the value of the contract, policy limits and premium received will require the insurer, as a matter of good practice, to reassess their coverage and pricing structures. It will also provide difficulties for insurers in assessing their reinsurance requirements and capital holding requirements under the Solvency II requirements.

5.21 Following the consultation by HM Treasury, three consultees objected to clause 14 in the Report's draft Bill, which implements this recommendation. Two stakeholders representing the London market stated in their joint response that the clause would generate undue litigation and add to costs. However, they indicated that they would support a more limited right to damages where an insurer refuses a claim which it either knows is valid or is reckless as to whether or not it is valid.

5.22 One insurer said that adequate customer protections already exist under the existing regulatory framework. There was a danger that the proposal would lead to claimants and/or their representatives using the threat of litigation as a tactic to speed up claims settlements undergoing an appropriate investigation. Legal challenges to settlement times would result in increased litigation and ultimately drive up the cost for customers.

NEXT STEPS

5.23 Damages for late payment are not included in the Bill currently before Parliament. We will continue to work with stakeholders to increase the consensus around this measure, with a view to introducing a statutory right to damages for late payment at the next legislative opportunity.

PART 6

GOOD FAITH

- 6.1 Section 17 of the Marine Insurance Act 1906 (the 1906 Act) imposes a duty of good faith on both parties. It states:

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

- 6.2 This has been held to reflect the common law for all types of insurance.
- 6.3 The characterisation of an insurance contract as a contract of “the utmost good faith” lies at the heart of insurance contract law. The main problem with section 17 is that it only provides one remedy: avoidance of the contract. This has been subject to widespread criticism. Although the duty of good faith is reciprocal, the remedy is capable of operating with considerable harshness against policyholders and is generally favourable to insurers.
- 6.4 Where an insurer has acted in bad faith, avoidance of the policy is generally an inappropriate remedy for the insured, who usually wants their claim paid. Where the insured is at fault and the insurer seeks a remedy, avoidance is often a harsh and disproportionate consequence which over-compensates the insurer.
- 6.5 Keeping the remedy of avoidance is not compatible with our recommendations for a new system of proportionate remedies for non-dishonest breaches of the duty of fair presentation. Nor is it compatible with our recommendations for fraudulent claims. Furthermore, we do not think that the remedy of avoidance is appropriate in other circumstances.

THE RECOMMENDED REFORMS

Removing avoidance as the remedy for breach of the duty of good faith

- 6.6 We propose an amendment to section 17 of the 1906 Act to remove the following statement:⁶⁸

...and, if the utmost good faith be not observed by either party, the contract may be avoided by the other party.

- 6.7 Following this reform, section 17 would simply state that “a contract of marine insurance is a contract based upon the utmost good faith”. In other words, good faith would remain as a general principle, but would not give rise to any specific remedy.

⁶⁸ See clause 15 of the draft Bill, and clause 13 of the final Bill. Discussed in Chapter 30 of the Report.

Good faith as an interpretative principle

6.8 While we have proposed specific provisions covering the principal examples of good faith in the form of fair presentation and remedies for fraud, a general statement is still useful. We envisage three roles for such a principle:⁶⁹

- (1) To interpret the duty of fair presentation. Both parties are expected to act in good faith in exchanging information. For example, if a court were to find that an insured had intentionally disclosed only the bare minimum of information, hoping that the insurer would fail to make further enquiries to reveal the full picture, the insured would not have acted in good faith and would therefore be in breach of the duty of fair presentation.
- (2) To inform the need to imply contractual terms into the policy under the traditional “business efficacy” test. Good faith provides a background when considering whether it is necessary to imply a particular term.
- (3) To leave some room for judicial flexibility. It is possible that the principle of a mutual duty of good faith could provide a solution to an especially hard case or emergent difficulty. Although we think such cases would be extremely rare, it is possible that the courts could develop the concept to prevent an insurer from relying on a right to deny a claim where it would be manifestly unfair to do so.

⁶⁹ Discussed in Chapter 30.