Law Commission
Reforming the law

Scottish Law Commission
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Insurance Contract Law: The Business Insured's Duty of Disclosure and the Law of Warranties: Joint Consultation

Summary

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The Law Commission and Scottish Law Commission

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

Third Consultation Paper in the Joint Insurance Law Project

SUMMARY

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INTRODUCTION

S.1 The English and Scottish Law Commissions are carrying out a joint review of insurance contract law. On 26 June 2012 we published a third, and final, Consultation Paper, dealing with two issues:

(1) A business policyholder's duty to give pre-contract information to an insurer; and

(2) The law of warranties.

S.2 The full paper is available on our websites, together with an impact assessment and other documents. See http://www.lawcom.gov.uk (A-Z of projects>Insurance Contract Law) and http://www.scotlawcom.gov.uk (See News column).

S.3 We seek responses by **26 September 2012**. We welcome responses in any form, but you may wish to use the response forms on our websites.

Please send responses either –

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

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

PREVIOUS WORK

S.4 We first considered these issues in our 2007 Consultation Paper,[1] which discussed how the duty of disclosure applied to both consumers and businesses. There was strong support for reforming consumer law in this area, and we decided to give this priority. The Consumer Insurance (Disclosure and Representations) Act received Royal Assent in March 2012, and we hope that it will be brought into force in spring 2013.

S.5 Most respondents thought that the law should also be reformed for business insurance, but concerns were expressed about some proposals. We have listened carefully and developed our thinking. Given the importance of finding a workable practical solution to the problems, we are taking the unusual step of consulting again.

S.6 In December 2011, we published a second Consultation Paper covering: damages for late payment; insurers' remedies for fraudulent claims; insurable interest; and policies and premiums in marine insurance.[2] We are now analysing the responses to this paper.

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

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

NEXT STEPS

S.7 We will publish a final Report and draft Bill on all the remaining issues, completing our insurance law project by the end of 2013.

THE BUSINESS INSURED'S DUTY OF DISCLOSURE

S.8 A policyholder often knows more about the insured risk than the insurer. It is therefore important to encourage the full and frank exchange of information before the insurance contract is made.

S.9 Under the current law, a prospective business policyholder must disclose material circumstances to the insurer. We propose to retain this duty. It enables the UK insurance market to provide insurance for a wide variety of large and specialist risks, efficiently and cost-effectively.

S.10 We think, however, that the duty of disclosure does not work as well as it should. It is too unclear, and the consequences of failure are too harsh. We propose reforms which build on current best practice.

THE CURRENT LAW[3]

Section 18 of the Marine Insurance Act 1906

S.11 The law in this area was codified in the Marine Insurance Act 1906 (the 1906 Act), which the courts apply to all forms of business insurance. Section 18 places an onerous duty on a business policyholder to disclose information to the insurer before concluding a contract. The statute does not require the insurer to ask questions or indicate what it wishes to know. Instead, the policyholder must work out what the insurer would consider relevant.

S.12 Section 18(1) states that the 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 widely as "every circumstance which would influence the judgment of a prudent insurer in fixing the premium, or determining whether he will take the risk". Although some exceptions to the duty are set out in section 18(3), these are written in archaic language and are poorly understood.

S.13 The consequences of failure are harsh. If the policyholder fails to disclose a material circumstance, the insurer may "avoid the contract". In other words, the insurer may treat the insurance contract as if it did not exist and refuse all claims under it.

Other provisions

S.14 The duty of disclosure in section 18 is supported by three other sections of the Marine Insurance Act 1906:

(1) Section 17 sets out the general principle. It states that an insurance contract is "based upon the utmost good faith".

[3] See the discussion in Part 2 of the Consultation Paper.

(2) Section 19 requires the policyholder's agent to disclosure material circumstances.

(3) Section 20 places a duty on the policyholder not to misrepresent material facts.

S.15 Again, if any of these three duties are breached, the insurer may avoid the contract with the policyholder.

A comparison with other jurisdictions

S.16 In Part 3 of the Consultation Paper, we consider how other countries deal with this issue. In all the jurisdictions discussed, the obligations on policyholders are less onerous than under UK law. In France and Germany, policyholders are not required to volunteer information. Instead the onus is on the insurer to ask questions. In Australia, New York and Ireland, there is a requirement on the policyholder to volunteer information, but the requirement is more limited than in the UK.

THE PROBLEMS

S.17 We identify two main problems: the business insured's duty of disclosure is too unclear and, where it has not be complied with, the insurer's remedy is too harsh.

The duty is too unclear

S.18 Many businesses fail to disclose all material circumstances. Research shows that even professional risk managers may fail to understand the law in this area – not because the words are complex, but because the concept is counter-intuitive. Despite continual warnings, few policyholders believe that the law really expects them to second-guess what the insurer wants to know.

S.19 Even if insurance buyers are familiar with the words of section 18, they may have little idea of how to meet the duty. Large companies are much more complex than they were in 1906, with knowledge spread through hundreds, if not thousands, of employees. It is unclear which knowledge is relevant to the insurer, or what a company "ought to know".

S.20 The law gives the impression that insurers may play a passive role, which can lead to "underwriting at claims stage". In other words, an insurer may accept a poor presentation and ask questions only once a claim arises. The words of section 18 suggest that if the insurer then discovers material circumstances which it was not told about, it may exercise its right to refuse the claim. The courts have used the doctrine of "waiver" to protect policyholders against this practice, but the case law may not be sufficiently clear or well-known.

S.21 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 see disclosure as a reciprocal process. The policyholder should make a fair presentation of the risk, and the insurer should communicate what it wishes to know.

The remedy is too harsh

S.22 Avoidance is an "all or nothing" remedy. We think this encourages an adversarial approach and fails to reflect the commercial realities of the situation.

S.23 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. This over-protects the insurer against the loss it might have suffered had the claim been paid, and it fails to act as a sufficient incentive for insurers to ask appropriate questions.

S.24 As a reaction against this harsh penalty, the courts sometimes strain their interpretation of the law to say that no non-disclosure has taken place. The policyholder may be paid their full claim, even though they failed to disclose a matter which would have led to a small increase in premium.

PROBLEMS IN PRACTICE

S.25 In Part 4, we summarise the evidence about how the duty of disclosure works in practice.[4] We draw on responses from consultees, a survey of Airmic members[5] and a report by the Mactavish Group.[6]

Poor understanding of the law

S.26 Many of those who buy insurance on behalf of companies fail to understand the duty imposed on them by the Marine Insurance Act 1906. The Mactavish Group found that 87% of buyers were unaware of how onerous the duty was. Furthermore, 65% demonstrated this ignorance by failing to review the information used to place their risks with insurers.

S.27 This also emerged from the responses to our 2007 Consultation Paper. As the Construction Industry Council put it, "there is little doubt that the current arrangements for insurance law are often little understood, even by relatively informed buyers of insurance".

Poor presentations

S.28 Secondly, there were widespread failures to provide the material information. The Mactavish Group reviewed over 100 market submissions, concluding that "the same weaknesses and limitations seem to crop up in almost all cases". They found many examples of material omissions, including:

(1) *cursory discussion of the end use to which products are put*. For example, companies failed to mention that apparently innocuous components may be used for risky medical, space or nuclear applications.

[4] Paras 4.20 to 4.52.

[5] Airmic, Non-disclosure of material information - Member Survey (2010). Airmic (the risk managers' association) represents insurance buyers for the largest companies.

[6] Mactavish Corporate Risk & Insurance - The Case for Placement Reform .The Mactavish Protocols (2011). The Mactavish Group is a research and consultancy business specialising in risk and insurance.

(2) *inadequate information about the firm's dependency on particular sources*. For example, a large UK retailer failed to mention that it had reduced the number of its suppliers and closed distribution centres.

(3) *failure to mention non-core activities*. For example, a manufacturing company failed to mention that it undertook sensitive contract testing work for third parties.

A reduced role for brokers

S.29 Most business insurance transactions involve a broker, who has a duty to assist with the presentation of the risk to insurers. The problem, however, is that broker fees have fallen sharply. The Mactavish Group estimated that in 2010 fees in the mid to large corporate sector were 25-30% lower than in 2007.

S.30 Consultees confirmed that brokers now have less time to investigate companies' activities and prepare presentations. We were told about "widespread de-skilling" across the industry, with fewer site visits and surveys.

Too many disputes

S.31 Section 18 of the 1906 Act generates a large number of disputes. In 2010, almost a third (31%) of Airmic members said that insurers had raised non-disclosure issues against them in the last five years. Of these, only around half reported that the claim had been resolved satisfactorily. There was also a high level of litigation: 5% of all Airmic members in the survey had been involved in litigation on the issue of non-disclosure in the last five years.

S.32 The issue leads to a high number of reported cases. We identified 41 reported judgments on section 18 from January 2002 to January 2012.[7]

"Underwriting at claims stage"

S.33 The Mactavish Group noted that after many years of a soft insurance market,[8] insurers have grown to accept lower standards in submission:

> The soft market puts underwriters under intense pressure to secure new business. They must operate with the knowledge that there are other penholders ready to write business on the back of the most meagre information in submission documents.[9]

S.34 The problems come when soft markets start to turn hard. If insurers discover that they have asked too few questions and underpriced the risk, they may raise issues of non-disclosure when a claim is made. The Mactavish Group thought that this could have serious consequences for businesses. It may mean delays in settlement, protracted negotiations about the size of the settlement, or even, in some cases, outright refusal of the claim.

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

[8] A soft market is where the availability of insurance outstrips demand, leading to lower premiums or more extensive cover.

REFORM FOR ALL BUSINESS INSURANCE

S.35 The proposals we make in this paper are aimed at all business insurance, whether that insurance is taken out by a micro-business or large multi-national business. They also cover marine insurance and reinsurance.

S.36 In 2009, we consulted on whether micro-businesses needed special protection.[10] Following investigations, we have decided against special rules for smaller businesses, for four reasons:

(1) It was extremely difficult to produce a clear definition of a micro-business, which could apply at the time the contract was formed.

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

(3) There was little real evidence of a problem. Micro-businesses are generally asked questions, which makes disclosure less onerous. The Mactavish Group commented that the most serious problems were experienced by mid-sized companies, with a turnover between £50 million and £5 billion.

(4) In cases of hardship, the Financial Ombudsman Service is already able to provide protection to micro-businesses.[11]

AN EVOLUTIONARY APPROACH

S.37 Our current proposals have three aims:

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

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

(3) to provide fair remedies.

S.38 For the first two aims, we take an evolutionary approach. We have analysed the cases in detail to clarify that a policyholder should make a fair presentation and the insurer should then ask appropriate questions. We also consider what a policyholder "ought" to know. We think it would be helpful to include the best principles drawn from the case law in the statute itself, to provide more guidance and certainty to policyholders and insurers.

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

[10] Issues Paper 5: Micro-Business (April 2009).

[11] Above, paras 1.10 to 1.15. For further discussion see Appendix A of the Consultation Paper.

S.39 This is intended to benefit larger businesses which are expected to present a risk. The new statute should provide the basic structure of reciprocal duties. We hope that both insurers and policyholders will work together to put flesh on these bones, by developing guidance and protocols to cover different markets. Some initiatives along these lines have already started and we hope that our reforms will stimulate further steps.

S.40 On the issue of remedies, we think that avoidance is appropriate where the policyholder has acted dishonestly. In other circumstances we propose a new system of proportionate remedies. This is intended to benefit all policyholders, including micro-businesses.

S.41 We are not proceeding with the "reasonable insured" test we proposed in 2007. We accept the criticism made by many consultees that such a test was too uncertain.[12]

A fair presentation of the risk

S.42 In Part 5 we analyse the case law on material circumstances. It establishes that an insured must disclose every material circumstance which is required to provide a fair presentation of the risk. This includes:

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

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

(3) standard information which market participants generally understand should be disclosed. This would enable the court to have regard to established protocols about what a presentation should include.

S.43 These principles are already found within the current case law, but they need to be more widely known. We propose to include them within the statute.

Prompting the insurer to ask questions

S.44 If the presentation of the risk suggests potential problems, the onus should then be on the insurer to ask further questions. Again, this principle is found in the existing case law. The courts have developed the law of waiver to deny a remedy to an insurer who has failed to ask appropriate questions, where the information it has received would prompt a reasonably careful insurer to do so.

S.45 We think that this important doctrine should be specifically mentioned in the legislation. We propose that where an insurer has received information that would prompt a reasonably careful insurer to make further enquiries and it fails to do so, it should not have a remedy for non-disclosure of any fact which those enquires would have revealed.

[12] See paras 4.60 to 4.71 of the Consultation Paper.

The inducement test

S.46 The courts have added a new test to the 1906 Act.[13] The insurer must show that without the non-disclosure or misrepresentation it would not have entered into the contact at all, or only on different terms.

S.47 For consumer insurance the inducement test has already been given statutory form.[14] In business insurance, the inducement test is also a significant part of the law and we think the opportunity should be taken to include it within the statute.

The policyholder's knowledge under section 18

S.48 Section 18(1) of the 1906 Act requires policyholders to disclose information which they know, or which they ought to know "in the ordinary course of business". In Part 6 we explain that this is a complex test which raises two difficult questions.

S.49 First, if the policyholder is a corporate entity, whose knowledge counts as the knowledge of that entity? Airmic notes that for large, complex international companies, "identification, collection and collation of all material information" can be a very difficult task.[15] It is particularly difficult to know whether information known only to some employees should be taken as known by the company as a whole.

S.50 Secondly, what "ought" the policyholder know? There is debate over whether this is objective or subjective, and how far the policyholder is under a positive duty to make enquiries before taking out insurance. The current law on these issues is malleable and driven by the facts of individual cases.

S.51 Again, we think it would be helpful to provide a fuller definition in the statute itself of what a corporate policyholder "knows or ought to know". In a large organisation the person who arranges the insurance cannot be taken to know everything known to every employee, but we think it would be helpful to insurers to clarify that the buyer must make reasonable enquiries.

S.52 We propose that where a business policyholder is a corporate entity, "knowledge" should include information known both to "the directing mind and will of the organisation" and to the persons who arranged the insurance on behalf of the organisation. In addition, a business policyholder should be under a duty to disclose information that would have been discovered by reasonable enquiries, which are proportionate to the type of insurance and to the size, nature and complexity of the business. We hope that the industry will develop protocols about the procedures a business should follow.

[13] *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co Ltd* [1995] 1 AC 501. The case mainly concerns non-disclosure but the inducement test applies equally to misrepresentation. For discussion, see the Consultation Paper, paras 5.61 to 5.67.

[14] Consumer Insurance (Disclosure and Representations) Act 2012, s 4(1).

[15] Airmic, *Disclosure of Material Facts and Information in Business Insurance* (2011).

The policyholder's knowledge under section 20

S.53 Under section 20 of the 1906 Act, the policyholder 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 practice the courts tend to find issues which the policyholder knew or ought to know about to be matters of fact. Other issues are likely to be matters of expectation or belief.[16]

S.54 We think it would be simpler and easier to apply the same knowledge test to both section 18 and section 20. We propose to amend section 20 to state that if a representation is one which the policyholder knew or ought to have known about (as defined above) then it must be true. If not, it must be made in good faith.

The broker's knowledge under section 19

S.55 Under section 19 of the 1906 Act, where the policyholder uses a broker or other agent to effect insurance, the agent is also required to disclose information to the insurer. In Part 7 of the Consultation Paper we analyse this provision in detail.

S.56 Section 19 appears to place a duty on the broker to the insurer, but this is misleading. The only remedy for breach of the section is that the insurer may avoid its contract with the policyholder. The effect of section 19, therefore, is to extend the policyholder's duty to the insurer, not only to disclose information which the policyholder knows or ought to know, but also to disclose some additional circumstances which are known only to the broker.

S.57 The law on section 19 is confused, with several contrary judicial statements about what it covers. We think that there is a need to clarify what the policyholder's agent "knows" or "ought to know" in this context.

S.58 We propose that the duty of disclosure should include any information received or held by the agent in the course of acting for the policyholder. This should apply to all brokers in the chain. On the other hand, we propose to clarify that the duty does not include information given to the broker by other clients.

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

S.59 Section 18(3)(b) of the Marine Insurance Act 1906 states that the policyholder need not disclose "any circumstance which is known or presumed to be known to the insurer". This is an important protection for policyholders. It covers matters of "common notoriety and knowledge" and matters which an insurer ought to know "in the ordinary course of his business".

S.60 In Part 8, we analyse the case law. We conclude that the courts have reached the right results, but that the principles need to be clearer and better known. We propose that, in the absence of enquiry, a business policyholder need not disclose matters of common knowledge or information relating to the risks of the trade which a well-informed insurer ought to know about.

[16] For discussion, see the Consultation Paper, paras 2.41 to 2.45 and paras 6.79 to 6.95.

S.61 We also propose to clarify what is meant by "known to the insurer". The policyholder need not disclose information already known to the person who makes the underwriting decision. Nor, in the absence of enquiry, need the policyholder disclose information held by the insurer's agent or employee which ought to have been communicated to the person making the underwriting decision.

NEW REMEDIES

S.62 At present, the law provides only one remedy for non-disclosure or misrepresentation: avoidance of the contract. This is appropriate where the policyholder has behaved dishonestly and therefore should suffer a penalty. In other cases we think that avoidance over-protects the insurer and encourages an unduly adversarial approach. In Part 9, we propose a new system of remedies.

Dishonest conduct

S.63 We propose that where the policyholder has behaved dishonestly, the insurer should be entitled to avoid the contract, refuse all claims and keep any premium paid.

S.64 We ask how dishonest conduct should be defined. One possibility would be to provide a new statutory definition of "deliberate" or "reckless" behaviour. This would include cases 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 the facts were relevant to the insurer or did not care whether they were relevant to the insurer.

S.65 Alternatively, the statute could refer to fraud and leave the definition to the courts.

Other conduct: proportionate remedies

S.66 For conduct which is not dishonest, we think that the law should aim to put the insurer into the position it would have been in had full and accurate information been provided. We propose a new default regime of proportionate remedies:

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

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

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

S.67 These remedies would be new for UK commercial insurance law, though they are widely used in Europe and in consumer disputes.

S.68 Most disputes in this area arise in the context of a claim: the future of the contract is of secondary importance. We ask whether the legislation should provide the insurer or the policyholder (or both) with a right to cancel the contract for the future.

Contracting out

S.69 For business insurance, the new remedies would be subject to the parties' freedom to contract. We do not expect that contracting out of the default regime would be routine, but in some specialist markets the parties may wish to retain avoidance as the remedy for non-disclosure and misrepresentation.

S.70 We propose that parties to a business insurance contract should be entitled to contract out of the proportionate remedies regime. This will be subject to the safeguard that a term purporting to contract out of the default regime is written in clear unambiguous language and is brought to the attention of the other party.

The effect on reinsurance

S.71 In Part 9 we consider the effect of proportionate remedies on reinsurance. Where reinsurance is written "back to back" with the direct insurance, we do not think that proportionate remedies would present problems. Where reinsurance has not been written on this basis, there may be many ways in which the reinsurer's liability to the insurer differs from the insurer's liability to the policyholder. This, however, can happen under the current law and in practice the reinsurance market has adjusted to this outcome.

S.72 Our proposals allow insurers and reinsurers to reach any agreement they wish, including to contract out of the default regime of proportionate remedies. We ask if consultees agree that the effect of proportionate remedies on reinsurance can be left to freedom of contract.

THE DUTY OF GOOD FAITH

S.73 Section 17 of the Marine Insurance Act 1906 imposes duties of good faith on both parties. Sections 18 to 20 of the 1906 Act are specific examples of that principle in relation to non-disclosure and misrepresentation, but section 17 also extends more widely. The duty applies to both the insurer and the policyholder, both before and after the contract has been formed.

S.74 In the course of our review, we have considered section 17 on several occasions. We summarise these discussions in Part 10 of the Consultation Paper. Section 17 provides only one remedy: avoidance of the contract. This is not compatible with the proportionate remedies we propose in Part 9. Nor is it compatible with the remedies for fraudulent claims we proposed in our 2011 Consultation Paper.[17]

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

S.75 We think that the duty of good faith should be retained as an interpretative principle but we do not think it should, in itself, give either a policyholder or an insurer a cause of action. Any remedies which are required, such as remedies for non-disclosure, misrepresentation or fraudulent claims, should be specified directly in the legislation. We also ask if section 17 should continue to refer to "utmost good faith", or simply "good faith".

WARRANTIES

S.76 In Chapter 2 of the Consultation Paper, we discuss the effect of warranties in insurance contracts and the consequences for the policyholder where a warranty is breached.

WHAT IS A WARRANTY?

S.77 There is considerable uncertainty over the word "warranty". In general contract law, "warranties" are relatively minor contractual terms. By contrast, an insurance warranty is a particularly important contractual term which, if breached may have harsh consequences for the policyholder.

S.78 Section 33(1) of the Marine Insurance Act 1906 (the 1906 Act) provides a potentially wide definition. It includes terms by which the policyholder undertakes to do or not to do some particular thing, or that some condition will be fulfilled (referred to as "promissory warranties"). It also includes terms whereby the policyholder "affirms or negatives the existence of a particular state of facts" (referred to as "warranties of past or present fact").

S.79 Identifying whether terms in insurance contracts are warranties is not easy. Merely calling a term a "warranty" is not enough. The courts have held that some terms are warranties even though the word is not used; while in other cases a term called a warranty may not be a "true warranty" in law. This uncertainty over what a warranty is has bedevilled attempts at reform.

PROBLEMS WITH THE CURRENT LAW

S.80 The current law of warranties set out in the 1906 Act appears unfair and unprincipled. There are four main problems:

(1) Under section 33(3) of the 1906 Act, a warranty "must be exactly complied with, whether it be material to the risk or not". This means that an insurer may refuse a claim for a trivial mistake which has no bearing on the risk.

(2) Under section 34(2), once a warranty has been broken, the policyholder cannot use the defence that the breach has been remedied. For example, if a policyholder is late in checking the alarm, it is irrelevant that when the loss arises, the alarm is has been checked and found to be working.

(3) The breach of warranty discharges the insurer from all liability under the contract, not just for liability for the type of risk in question. Thus a failure to install the right sort of burglar alarm would discharge the insurer from paying a claim for flood damage.

(4) A statement may be converted into a warranty using obscure words that most policyholders do not understand. If, for example, a policyholder signs a statement on the proposal form that the answers given are "the basis of the contract", this can have draconian consequences.

MODERATING HARSH LAW THROUGH STRICT INTERPRETATION

S.81 For many years, the courts have attempted to moderate the harshness of the law. A warranty may be construed strictly against the party who has put it forward.[18] Alternatively, a term which appears to be a warranty may be construed as some other type of term, such as a "suspensive condition", which only applies for the duration of the breach.[19]

S.82 This approach has allowed the courts do justice in individual cases. We have been told that it discourages insurers from taking purely technical points, or attempting to use warranties in a wholly unreasonable way. While this has its advantages, it also introduces complexity and uncertainty into the law.

THE NEED FOR REFORM

S.83 The law of warranties has attracted criticism for many years. Responses to our 2007 Consultation Paper showed widespread support for reforming the law. Many responses agreed that the current law is "archaic", "blunt" or "unfair". The Faculty of Advocates felt that reform was needed in "the interests of legal certainty and to enable the law to reflect current practice and a fair balance between interested parties".

S.84 Many insurers and insurance organisations also argued in favour of reform. RGA Reinsurance UK Ltd, for instance, said:

> Law reform has been recommended for many years and we are firmly of the view that now is the appropriate time to bring it up to date.

S.85 We think that the current law of warranties risks bringing the law in the UK into disrepute in the international marketplace. As we explore in Part 13 of the Consultation Paper, warranties do not have a direct equivalent in civil law countries. The Marine Insurance Act 1906 was exported to other common law jurisdictions, but many have now reformed their laws to give greater protection to policyholders (including Australia and New Zealand).

THREE PROPOSALS FOR REFORM

S.86 Part 15 sets out three main proposals to reform the law of warranties:

(1) *To abolish basis of the contract clauses*. Insurers may still use warranties of past or present fact, but they should be included specifically in the contract.

(2) *To treat warranties as suspensive conditions*. A breach of warranty would suspend the insurer's liability, rather than discharge it. Where the breach is remedied before the loss, the insurer must pay the claim.

[18] *Provincial Insurance Company Ltd v Morgan & Foxton* [1933] AC 240. For discussion see paras 12.44 to 12.59.

[19] *Kler Knitwear v Lombard General Insurance Co Ltd* [2000] Lloyd's Rep IR 47.

(3) *To introduce special rules for terms designed to reduce the risk of a particular type of loss, or the risk of loss at a particular time or in a particular location*. For these terms, a breach would suspend liability in respect only of that type of loss (or a loss at that time or in that place). Thus, for example, the breach of a warranty to install a burglar alarm would suspend liability for loss caused by an intruder but not for flood loss.

S.87 In consumer insurance, the proposed consequences of breach of warranty could not be excluded by a contract term. In business insurance, the parties would be able to contract out of these provisions, provided they did so in clear, unambiguous terms and the term was brought to the attention of the other party.

S.88 We propose that the default regime for breach of warranty should apply to reinsurance. If the parties wish to come to another arrangement, they would be free to do so.

Proposal 1: Abolishing basis of the contract clauses

S.89 Basis of the contract clauses have been described as "traps" as they allow the insurer to refuse claims on the basis of minor and irrelevant mistakes.[20] If a prospective policyholder signs a statement on a proposal form stating that the answers given form the "basis of the contract", this has the effect of converting all the answers into warranties. Any inaccuracy, no matter how minor, will discharge the insurer from liability for loss. This provides the insurer with a remedy which goes beyond that available to it for misrepresentation under section 20 of the 1906 Act.

S.90 The Consumer Insurance (Disclosure and Representations) Act 2012, section 6 prevents insurers using basis of the contract clauses in consumer insurance contracts.

S.91 We propose that a similar provision should apply to business insurance. It should not be possible for an insurer to use a contract term to convert the answers in a proposal form into warranties. If the insurer wishes to include specific warranties, they would need to be spelled out in the contract.

Proposal 2: Treating warranties as suspensive conditions

S.92 Section 33(3) of the 1906 Act states that a warranty must be exactly complied with. If not, "the insurer is discharged from liability as from the date of the breach of warranty". Remedy of the breach by the policyholder before loss is of no effect as section 34(2) provides that the policyholder cannot rely on that fact as a defence.

S.93 This is clearly unjust. It is wrong, for example, to refuse a claim for delay in inspecting a sprinkler system when, at the time of loss, the sprinkler has been inspected and is working perfectly. In attempting to escape the harshness of the 1906 Act provisions, the courts have been forced to reinterpret terms, introducing confusion into the law.

[20] *Zurich General Accident & Liability Insurance Co v Morrison* [1942] 2 KB 53, 58 by Lord Greene MR.

S.94 We propose to change the law to the effect that if a warranty is not complied with, the insurer's liability is suspended for the duration of the breach. If the breach is remedied, liability would be restored.

S.95 The proposal treats warranties and other exclusion clauses in the same way: liability would be suspended. We do not think that this is a controversial proposal. Insurers value warranties as an effective means to manage risk, but most do not wish to use warranties oppressively where faults have already been remedied. It is also in line with the approach already taken by the courts.

Proposal 3: Terms to reduce particular risks

S.96 Proposal 3 would apply to any term which has the purpose of reducing particular risks. Where a term is designed to reduce the risk of a particular type of loss, a breach of that term would only suspend liability in respect of that type of loss. Thus, for example, failure to comply with a requirement to maintain fire retardant lagging in kitchen ducting should suspend liability for fire loss but not theft loss.

S.97 The same would apply where the term is designed to reduce the risk of loss at a particular time or in a particular location. A failure to employ a night watchman, therefore, should suspend the insurer's liability for losses at night, but not for losses during the day.

S.98 Proposal 3, unlike Proposal 2, would not apply solely to warranties as traditionally defined. Instead it would apply to any term which had the purpose of reducing the risk of a particular type of loss, or of loss at a particular time or in a particular place. Some of these terms may well be warranties, while others might not.

S.99 As we explain above, this is a default rule. In business insurance, if an insurer wished to specify that the failure to employ a night watchman would discharge it from all liability under the contract, it would be entitled to do so – but the term that provided for this would need to be in clear, unambiguous language and specifically brought to the attention of the policyholder.

NO CAUSAL CONNECTION TEST

S.100 In 2007, we proposed that policyholders should be entitled to be paid claims if they could prove that the event or circumstances constituting the breach of warranty did not contribute to the loss. Many consultees feared this would introduce unnecessary complexity and uncertainty.

S.101 We are no longer proceeding with this proposal. We accept that a causal connection test is unsuited to many terms (such as those which define the purpose of the insurance, or the geographical area covered). It would also be difficult to apply the test to warranties and not to suspensive conditions.

S.102 We think that our current proposals protect policyholders against the unfairness we have identified in a simpler and more straightforward way. They treat warranties in a similar way to suspensive conditions, removing unnecessary distinctions between the two.

MARINE INSURANCE

S.103 In Part 16 we discuss warranties in marine insurance. As far as express warranties are concerned, we propose that our three reform proposals should apply.

S.104 We also consider the implied warranties and voyage conditions set out in the Marine Insurance Act 1906. We propose that these should be retained, with one change. We think that where an implied warranty has been breached, the insurer's liability should be suspended, rather than discharged. Under the current law, if a ship leaves port with insufficient medicines, for example, the implied warranty of seaworthiness is breached, and the insurer is discharged from all liability. Under our proposals, liability would be resumed once the medicine supply had been replenished.