Law Commission and Scottish Law Commission

CONSUMER INSURANCE LAW: PRE-CONTRACT DISCLOSURE AND MISREPRESENTATION Joint Report

OUTLINE

1.1 The English and Scottish Law Commissions recommend new legislation covering the issue of what a consumer should tell an insurer before taking out insurance. The report includes a draft Bill to be laid before Parliament.

1.2 The current law requires consumers to volunteer information about everything which a "prudent insurer" would consider relevant. A failure to do so allows the insurer to treat the insurance contract as if it never existed and refuse all claims under the policy.

1.3 The Commissions recommend that the consumer's duty to volunteer information to the insurer should be abolished. Instead, insurers should be required to ask questions about the things they want to know. Consumers would then have a duty to take reasonable care to answer those questions fully and accurately. If a consumer provides information which was not asked for, they must take reasonable care to ensure that it is not misleading.

1.4 The Commissions' recommendations reflect the approach already taken by the Financial Ombudsman Service (FOS) and generally accepted good practice within the insurance industry. However, the draft Bill would enshrine this good practice in law. It would make the law simpler and clearer. Insurers would be less likely to turn down claims unfairly and consumers would have greater confidence in the insurance industry.

Problems with the current law

1.5 Parliament passed the Marine Insurance Act in 1906. Although this Act was designed for shipping, the courts have held that it applies to all insurance, including consumer insurance. It imposes a "duty of disclosure" on everyone who buys insurance.

1.6 There are four main problems with the 1906 Act:

(1) The duty to disclose may operate as a trap for consumers, who are usually unaware that the duty exists.

(2) Policyholders may be denied claims even when they have acted honestly and reasonably.

(3) The remedy may be overly harsh. If the consumer has made a mistake, the insurer may refuse all claims, even claims which it would have paid had it been given full information.

(4) Proposal forms sometimes state that the answers "form the basis of the contract". In law, this means that if any statement is incorrect, the insurer may refuse all claims, even if the mistake is unimportant.

1.7 To mitigate the harshness of the law, consumer insurance has been subject to an array of industry codes, Financial Services Authority (FSA) rules and FOS discretion. These various rules and codes are overlapping and inconsistent.

1.8 For example, FSA guidance suggests that insurers should *either* ask clear questions *or* explain the duty of disclosure. As a result, insurers often warn consumers that "failure to disclose any material information may invalidate your insurance cover". However, the FOS, which has statutory power to determine consumer complaints according to what is "fair and reasonable", takes a different view. It does not require consumers to disclose material information, but only to answer the questions asked by the insurer.

1.9 Consumers who are treated unfairly may complain to the FOS. Each year, around a thousand consumers complain to the FOS about a claim being refused for reasons of non-disclosure. However, the FOS may only make binding awards up to £100,000. Where the claim is for a greater amount, it can do no more than recommend that the insurer pays the additional money. The FOS will also refuse cases which require witnesses to be cross-examined. If the consumer takes the case to court, the court is forced to apply the Marine Insurance Act 1906.

1.10 Some insurers do not understand what the FOS requires – and consumers who have been treated unfairly may not realise that they have a right to complain to the FOS. The overall confusion leads to a loss of confidence in the insurance industry. It also penalises some vulnerable groups, including older consumers and those with criminal convictions. The problems are particularly acute for those whose early symptoms are difficult to diagnose, such as those with multiple sclerosis.

The consultation process

1.11 In 2006, the two Law Commissions set up a joint review of insurance law. We published a consultation paper in 2007 and received over a hundred responses. The vast majority of consultees, including most insurers, supported consumer insurance reform.

The draft Bill

1.12 The Commissions have drafted a short, targeted Bill. It applies only to consumers and deals only with the issue of what a consumer must tell an insurer before entering into or varying an insurance contract. It abolishes the consumer's duty to volunteer material facts. Instead, consumers must take reasonable care to answer their insurer's questions fully and accurately. If consumers do volunteer information, they must take reasonable care to ensure that the information is not misleading.

1.13 Where an insurer has been induced by a misrepresentation to enter into an insurance contract, the insurer's remedy will depend on the nature of the misrepresentation:

(1) If the misrepresentation was *honest and reasonable*, the insurer must pay the claim. The consumer is expected to exercise the standard of care of a reasonable consumer, taking into account a range of factors including the type of insurance policy and the clarity of the insurer's question.

(2) If the misrepresentation was *careless*, the insurer has a compensatory remedy based upon what the insurer would have done had the consumer taken care to answer the question accurately. If the insurer would have excluded a certain illness, for example, the insurer need not pay claims which would fall within the exclusion but must pay all other claims. If the insurer would have charged more for the policy, it must pay a proportion of the claim.

(3) If the misrepresentation was *deliberate or reckless*, the insurer may treat the policy as if it never existed and may decline all claims. It would also be entitled to retain the premiums, unless there was a good reason why they should be returned.

1.14 The new scheme is best thought of as a series of questions which the insurer, court or ombudsman must ask before deciding to reject all or part of the claim. These questions are set out as a flow diagram overleaf.

Other issues

1.15 The draft Bill also:

(1) Explains what is meant by "reasonable care" and "deliberate or reckless" misrepresentations.

(2) Establishes a statutory code to determine for whom an intermediary (an "agent" or "broker") acts when arranging insurance. This code is based largely on the existing law, as supplemented by FOS practice and industry understanding.

(3) Abolishes "basis of the contract" clauses.

(4) Includes special provisions for group schemes, where one party (typically an employer) arranges insurance to benefit members of the group. The draft Bill provides that where one group member makes a misrepresentation, it has consequences only for that individual and not for others within the group.

(5) Prevents insurers from contracting out of the scheme to the detriment of the consumer.

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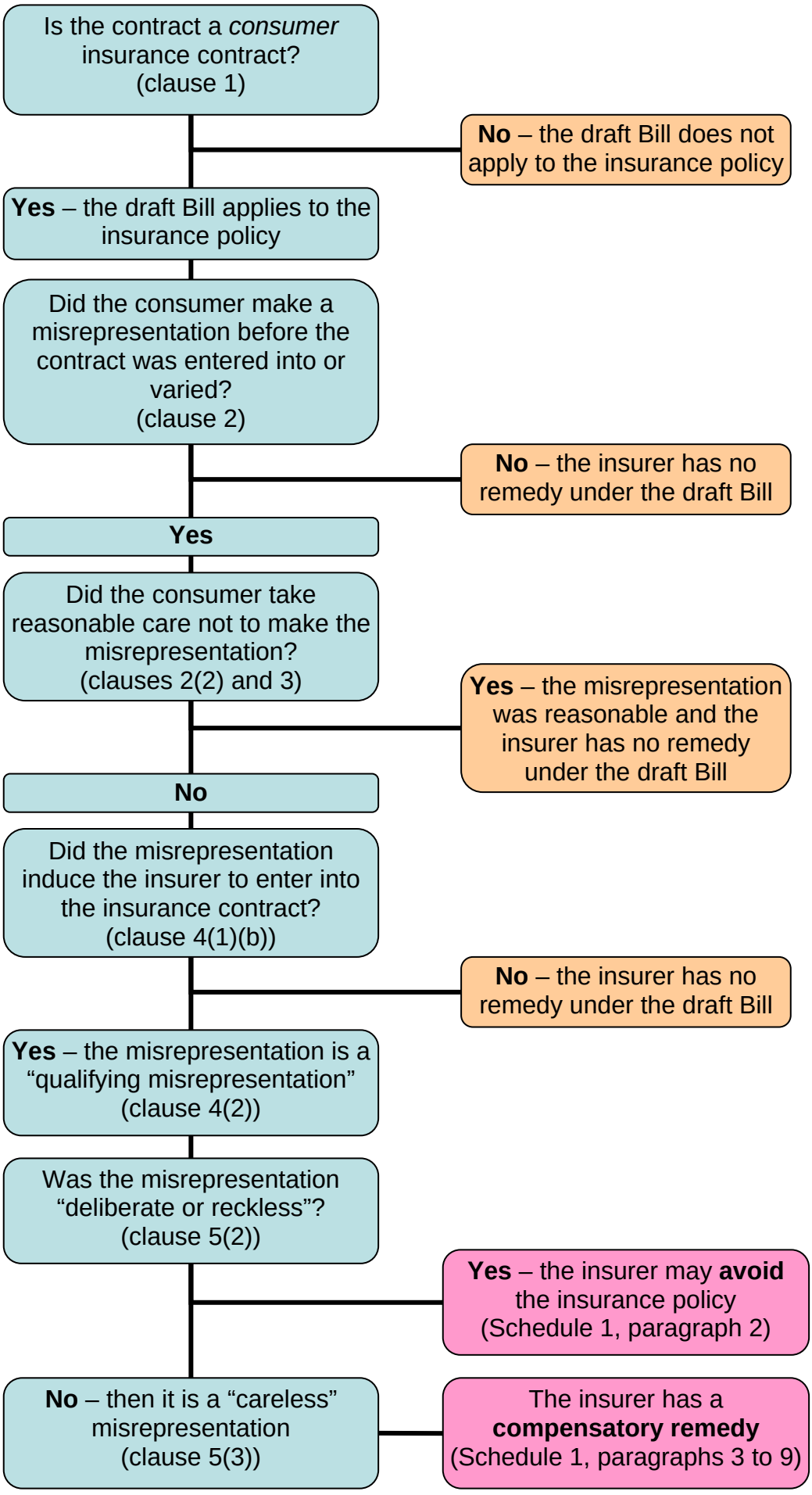
Is the contract a *consumer* insurance contract? (clause 1)
No – the draft Bill does not apply to the insurance policy
Yes – the draft Bill applies to the insurance policy
Did the consumer make a misrepresentation before the contract was entered into or varied? (clause 2)
No – the insurer has no remedy under the draft Bill
Yes
Did the consumer take reasonable care not to make the misrepresentation? (clauses 2(2) and 3)
Yes – the misrepresentation was reasonable and the insurer has no remedy under the draft Bill
No
Did the misrepresentation induce the insurer to enter into the insurance contract? (clause 4(1)(b))
No – the insurer has no remedy under the draft Bill
Yes – the misrepresentation is a "qualifying misrepresentation" (clause 4(2))
Was the misrepresentation "deliberate or reckless"? (clause 5(2))
Yes – the insurer may **avoid** the insurance policy (Schedule 1, paragraph 2)
No – then it is a "careless" misrepresentation (clause 5(3))
The insurer has a **compensatory remedy** (Schedule 1, paragraphs 3 to 9)