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Commission**
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Scottish Law Commission
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Insurance Contract Law: Post Contract Duties and other Issues: Joint Consultation Paper

Summary

LCCP 201 / SLCDP 152 (Summary)
December 2011

**The Law Commission and Scottish Law
Commission**

**INSURANCE CONTRACT LAW: POST CONTRACT
DUTIES AND OTHER ISSUES**

Second Consultation Paper in the Joint Insurance Law
Project

SUMMARY

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INTRODUCTION

- S.1 On 20 December 2011, the two Law Commissions published a Consultation Paper on possible changes to insurance contract law. It covers four topics:
- (1) Damages for late payment (Chapter 1);
 - (2) Insurers' remedies for fraudulent claims (Chapter 2);
 - (3) Insurable interest (Chapter 3);
 - (4) Policies and premiums in marine insurance (Chapter 4).
- S.2 This follows a previous Consultation Paper in 2007 on Misrepresentation, Non-Disclosure and Breach of Warranty. We have also published five Issues Papers on the subjects covered by this present consultation.
- S.3 The full Consultation Paper is available on our websites, together with previous documents and a full impact assessment of our proposals. See <http://www.lawcom.gov.uk> (A-Z of projects>Insurance Contract Law) and <http://www.scotlawcom.gov.uk> (See News column).
- S.4 We are seeking responses by **20 March 2012**. Respondents may wish to respond on one or more subjects, or to the full paper. We have created a response form on each of the four subjects, which may be downloaded from our websites, but consultees should feel free to submit a response in any form.

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

- S.5 We plan to publish a third Consultation Paper in 2012 on pre-contract non-disclosure in business insurance and the law of warranties. Following consultation on this paper and the next, we will publish a final report and draft Bill, completing our insurance law project by the end of 2013.

DAMAGES FOR LATE PAYMENT

- S.6 We consider the position of an insured who suffers further loss when an insurer unreasonably delays payment or wrongly rejects a valid claim.
- S.7 The normal position in contract law is that where one party suffers loss because the other party has failed to meet its contractual obligations, the innocent party may claim damages for loss suffered. Damages are restrained. The victim must prove that they suffered actual financial loss; that the loss was foreseeable at the time the contract was made; and that they have taken reasonable steps to mitigate it.¹

ENGLISH LAW: DAMAGES ARE NOT AVAILABLE

- S.8 The English courts have held that insurance contracts are an exception to this normal rule. In English law an insurer is not liable for any loss caused by its delay or failure to pay a valid claim. This rule is based on a fiction that an insurer's primary obligation is not to pay valid claims but to prevent the loss from occurring. Payment under the policy represents damages, and further damages cannot be awarded for the non-payment of damages.
- S.9 This is a surprising view. As one judge put it, property insurers may be surprised to discover that, on this argument:

they are, collectively, in breach of contract hundreds or thousands of times every day, whenever a fire, a flood, a road accident or other such event occurs.²

SPRUNG V ROYAL INSURANCE (UK) LTD

- S.10 The case of *Sprung* illustrates the problem.³ Mr Sprung ran a small business. When vandals broke in and damaged his factory, he submitted a claim to his insurer but his claim was rejected. In difficult economic conditions, Mr Sprung was unable to finance the repairs himself. Six months later, he was out of business.
- S.11 Mr Sprung started proceedings against his insurers. Four years later, the court found that his claim was valid, and should have been paid. Mr Sprung was awarded an indemnity for his lost plant and machinery, plus simple interest and costs. The judge also found that as a result of the insurer's failure, Mr Sprung had suffered a further loss of £75,000.

¹ For further discussion, see Consultation Paper, paras 2.6 to 2.13.

² *Transthene Packaging Co Ltd v Royal Insurance (UK) Ltd* [1996] Lloyds' Rep IR 32, at 40. See Consultation Paper, paras 2.19 to 2.38.

³ [1999] 1 Lloyd's Rep IR 111.

- S.12 Mr Sprung was not, however, entitled to claim this further loss. The Court of Appeal, with “undisguised reluctance”, considered itself bound by the rule that there could be no award of damages for late payment. Lord Justice Beldam called for reform of the law.⁴
- S.13 Although the decision in *Sprung* has been criticised, it appears well-established. In the consultation we discuss five cases in which *Sprung* has been upheld.⁵

AN ANOMALOUS AND ISOLATED RULE

- S.14 As we discuss in Parts 2 and 3, the rule in *Sprung* is increasingly anomalous and isolated:
- (1) It is out-of-step with normal contract law principles.⁶
 - (2) It does not apply in Scotland. Under Scots law, an insurer's obligation is to pay valid claims within a reasonable time. A failure to pay may give rise to damages subject to ordinary contract law principles.⁷
 - (3) It does not apply to life insurance.⁸
 - (4) It does not apply where the insurer has agreed to reinstate the property.⁹
 - (5) The Financial Ombudsman Service (FOS) frequently compensates consumers for distress and inconvenience, though awards tend to be low.¹⁰ The FOS also hears cases from micro-businesses, and is prepared to award compensation for proven losses. Generally, the FOS requires claimants to prove their losses to a high standard, but some large awards have been made, including one maximum award of £100,000. We are told that the insurance industry appears to accept the approach taken by the FOS.¹¹
 - (6) The FSA rules require insurers to handle claims promptly and fairly.¹² If not, consumers and some unincorporated businesses may be able to claim damages under section 150(1) of the Financial Services and Markets Act 2000. This is a complicated and restricted provision, however, which is not available to companies for business losses.¹³

⁴ Above, at 119. See Consultation Paper, paras 2.14 to 2.18.

⁵ See Consultation Paper, paras 2.39 to 2.54.

⁶ See Consultation Paper, paras 2.33 to 2.38.

⁷ *Strachan v The Scottish Boatowners' Mutual Insurance Association* 2010 SC 367. A similar approach is adopted in other common law jurisdictions. See Consultation Paper, paras 2.62 to 2.71.

⁸ Consultation Paper, para 2.59.

⁹ Consultation Paper, para 2.60. See also Issues Paper 6, paras 5.29 to 5.35.

¹⁰ They exceed £1,000 only in exceptional circumstances: Consultation Paper, para 2.79.

¹¹ See Consultation Paper, paras 3.27 to 3.31.

¹² ICOBS Rule 8.1.1.

¹³ See Consultation Paper, paras 3.19 to 3.26.

THE CASE FOR REFORM

- S.15 Responses to our Issues Paper indicated widespread support for reform. Out of the 32 responses we received, all but one agreed that the law in this area should be reformed. As the Association of British Insurers (ABI) put it:

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.¹⁴

- S.16 As we describe in Part 4, three criticisms were made of the current position:

- (1) *The law is unprincipled.* Respondents described the idea that an insurer was under an obligation to hold an insured harmless as “an arcane and wholly indefensible concept”.¹⁵
- (2) *The law is unfair.* As the British Insurance Brokers’ Association (BIBA) put it:

Consumers buy insurance to protect their possessions and businesses buy to protect their assets and liabilities. Any delay in payment can negate that protection.

Airmic¹⁶ argued that if a business is to survive the post loss recovery period, payment must be timely. Yet the law “does nothing to encourage reasonable behaviour on the part of the insurer”. We were told the issue has become more acute in the current economic climate, as firms find it more difficult to obtain bridging loans.¹⁷

- (3) *The rule reduces the perceived fairness and competitiveness of English law.* We were told that some corporate clients with international experience regard English law as excessively insurer-friendly, and may therefore seek out other legal systems to govern their insurance contracts.¹⁸

- S.17 That said, several industry organisations argued in favour of a cautious approach. They stressed that a change in the law should not prevent insurers from investigating claims fully. Insurers also pointed out that the amount of a policyholder’s loss may be disproportionate to the size of the claim. They were keen that insurers should be able to put a limit on liability to be able to reserve claims. We agree with these points.¹⁹

¹⁴ Consultation Paper, para 4.4.

¹⁵ Response from G Lloyd and D Cole. See Consultation Paper, paras 4.6 to 4.7.

¹⁶ Airmic represents insurance buyers for around three-quarters of FTSE 100 companies.

¹⁷ See Consultation Paper, paras 4.8 to 4.10.

¹⁸ See Consultation Paper, paras 4.11 to 4.13.

¹⁹ See Consultation Paper, paras 4.17 to 4.21.

PROPOSALS FOR REFORM

- S.18 We think there is a strong case for reform, and welcome views on the following proposals.

A statutory duty to pay valid claims

- S.19 Our main proposal is to re-characterise the insurer's primary obligation not as a duty to prevent loss but to pay valid claims after a reasonable time. An insurer who unreasonably delays or wrongfully repudiates a claim should be liable to pay damages according to normal contract law principles – that is for proven and foreseeable losses.
- S.20 We think legislation is needed. Most consultees told us that the prospect of judicial reform was too slow and uncertain.²⁰

A reasonable time to investigate, following a “clean claim”

- S.21 We propose that the definition of a reasonable time should be flexible, taking into account market practice, the type of the insurance, and the size, location and complexity of the claim.
- S.22 We accept that insurers need enough time to investigate claims fully. Thus we propose that a “reasonable time” should include sufficient time for full investigation and assessment of the loss. Provided that an insurer has acted reasonably in notifying the insured of the information it needs, the insurer's time to investigate should only begin on receipt of a “clean claim” (that is, once the insured has provided all material information). The insurer should have sufficient time to carry out a full investigation, including time to seek information from third parties where necessary.
- S.23 Once the investigation is complete, however, the insurer should assess the claim and communicate its decision promptly. This is similar in principle to the current FSA rules.²¹

Business insurance: liability could be excluded for decisions made in good faith

- S.24 We propose to preserve freedom of contract. In business insurance, an insurer would be able to use a contract term to limit or exclude its liability to pay damages for late payment, provided that the insurer has made an honest error in good faith. There may be good commercial reasons to limit damages, to enable insurers to reserve claims and put the necessary reinsurance provisions in place. We think that policyholders would be less likely to agree to a total exclusion of liability, but some may be willing to do so, in exchange for a suitable reduction in premium.²²

²⁰ See Consultation Paper, paras 5.5 to 5.9.

²¹ See Consultation Paper, paras 5.10 to 5.14.

²² See Consultation Paper, paras 5.15 to 5.25.

- S.25 On the other hand, we do not think that insurers should be able to exclude liability for losses brought about by their own bad faith. No policyholder who is properly advised would agree to allow an insurer to delay or reject a claim in bad faith. That would be inimical to the nature of an insurance contract.
- S.26 Where there has been unreasonable delay and the insurer seeks to rely on an exclusion of liability, we propose that the insurer should be required to explain why it acted as it did. It would then be open to the courts to evaluate whether the decision was one which could have been taken by an insurer acting in good faith, given the circumstances and the information available at the time.
- S.27 For example, if an insurer reasonably but mistakenly decides that a claim is disallowed under the policy, it should be able to rely on its exclusion clause. But if claims handlers delayed or rejected a claim they knew to be valid to secure a bonus payment, then the exclusion should not apply.²³

Consumer insurance: a non-excludable duty

- S.28 By contrast, we propose that in consumer insurance, insurers should not be entitled to exclude liability for failing to pay valid claims within a reasonable time. The FOS already recognises such a duty, and this appears to be accepted by the industry.²⁴

Application to Scotland

- S.29 Although the scheme of rules set out in paragraphs 1.19-1.28 is principally a reform of the law in England & Wales, we think that it should also be applicable in Scotland as well as in England & Wales, in the interests of legal certainty and consistency across the UK, given the scarcity of Scottish appellate decisions on the matter.

Limitation of actions in England and Wales

- S.30 Our proposals have implications for the time available to a policyholder to commence litigation against an insurer for failing to pay an insurance claim. At present, the breach is said to occur at the time of the loss and the victim has six years to make a claim. Under our proposals, the breach will not occur until the claim has been made and the insurer has had a reasonable time to investigate it.
- S.31 We consider three possible options:
- (1) To preserve the existing rule that time runs from the point of loss. This is relatively certain, but undermines the principle that the limitation period for breach of contract should only begin once the loss has occurred.
 - (2) To follow the logic of our proposals, and hold that time runs from breach of contract. This leaves the logic behind limitation periods intact.

²³ See Consultation Paper, paras 5.26 to 5.33.

²⁴ See Consultation Paper, paras 5.20 to 5.25.

- (3) To provide that time runs from when the insurer makes its decision. We think this may be too uncertain, and the insurer may write a chain of letters dealing with various aspects of the claim.
- S.32 Our preference would be for the limitation period to begin from the breach of contract, but we welcome views on this.
- S.33 We do not propose any change to the Scots law of prescription.²⁵

Damages for distress and inconvenience in consumer insurance

- S.34 In general consumer law, where a service has been sold to provide peace of mind, damages for distress and inconvenience would be available in appropriate cases.²⁶ There appears to be a rule in English law, however, that such damages are not available in consumer insurance.²⁷
- S.35 Yet consumer insurance is usually sold to provide peace of mind. Distress damages may be particularly relevant, for example, where a consumer's home has been left in serious disrepair for a prolonged period or where there has been a delay in approving medical treatment. We note that it may already be possible for Scottish courts to award damages in such cases.
- S.36 We propose that damages for distress, inconvenience or discomfort should be made available to the consumer. We ask whether statutory reform is the best way of achieving this throughout the UK.²⁸

²⁵ See Consultation Paper, paras 5.38 to 5.48.

²⁶ See Consultation Paper, paras 2.72 to 2.75.

²⁷ See *England v Guardian Insurance Ltd* [1999] 2 All ER (Comm) 481.

²⁸ See Consultation Paper, paras 5.49 to 5.56.

INSURERS' REMEDIES FOR FRAUDULENT CLAIMS

- S.37 Fraudulent insurance claims are a serious and expensive problem. The civil law must take a robust approach to deterring fraud by imposing a clear penalty on those who act dishonestly. Unfortunately, the law is not as clear as it should be. Although it is well-established that a policyholder who fraudulently exaggerates an insurance claim forfeits the whole claim, there is considerable uncertainty about the effect of a fraud on other claims made under the policy.

THE CURRENT LAW

The common law rule

- S.38 Since the nineteenth century, the courts have held that a person who fraudulently exaggerates a claim forfeits the whole claim. An example is *Galloway v Guardian Royal Exchange (UK) Ltd.*²⁹ Mr Galloway was burgled and suffered a genuine loss of around £16,000. However, he also fabricated a claim for a fictitious computer for around £2,000. The Court of Appeal rejected the whole claim, including the £16,000 of genuine loss. We think this is right. It is important that fraudsters should face due sanctions.

The duty of good faith: section 17 of the Marine Insurance Act 1906

- S.39 There is a mismatch between this common law rule and the duty of utmost good faith, as set out in section 17 of the Marine Insurance Act 1906.³⁰ Section 17 specifies only one remedy for failing to observe good faith: avoidance of the contract. This means avoiding the contract from the start. In theory, insurers could require policyholders to repay all claims which had been paid under the policy, including genuine and legitimate claims finalised and paid before the fraud arose.
- S.40 In practice, the courts have been reluctant to allow insurers to recoup valid claims which arose before the fraud took place. Finality is a core value of law in the UK: if a valid claim is paid under a valid contract, it seems wrong to attempt to overturn that payment on the basis of subsequent events.³¹

THE NEED FOR REFORM

- S.41 The mismatch has led to complex and inconsistent case law. As the ABI put it:

The duty not to make a fraudulent claim has been characterised in several irreconcilable ways by the courts.... Alternative positions have thus been created as to the remedies available to insurers in respect of fraudulent claims, but none long-established.

²⁹ [1999] Lloyd's Rep IR 209.

³⁰ This has been held to apply to all insurance, not just marine insurance.

³¹ See Consultation Paper, paras 6.4 to 6.52.

S.42 The great majority of respondents to our Issues Paper agreed that legislation was needed to clarify this confusing area. Of the 25 responses that addressed the question, all but two thought that it would be helpful to introduce legislation to clarify the insurers' remedies.³²

OUR PROPOSALS

S.43 Our proposals are relatively narrow. We deal only with the civil remedies, leaving the definition of fraud to the common law. Nor do we address criminal sanctions, which are outside the scope of this project.

S.44 Given the prevalence of fraud, we think it is important to set out clear sanctions in the civil law. The more confused the rules, the less they will deter fraud.

A statutory restatement

S.45 We propose to set out the remedies in statute. There are four main elements:

- (1) A policyholder who commits a fraud *should forfeit the whole claim to which the fraud relates*. Any interim payments made in respect of the claim must be repaid. This is the current law, which we intend to preserve.
- (2) The policyholder *should also forfeit any claim which arises after the date of the fraud*. The law on this point is uncertain, although we were told it is current market practice to refuse subsequent claims. We think the point needs to be clarified.
- (3) The fraud *should not affect any previous valid claim* where the loss arises before the fraud takes place, whether or not the claim has been paid. In theory, section 17 appears to give insurers a right to recoup previous claims, but in practice the courts do not permit it. It is an unprincipled and impractical remedy, which introduces confusion into the law.
- (4) The insurer should also have a right to claim *the costs reasonably and actually incurred in investigating the claim*, provided that these costs are not offset by savings from legitimate, forfeited claims. At present, the law does not appear to allow insurers to claim damages for investigation costs. We do not think such a right would be used often, but it would be an important sanction against major fraud, where the whole claim has been fabricated.³³

Express terms extending insurers' remedies

S.46 Many insurance contracts use express "fraud clauses" to extend the insurer's remedies for fraud. We provisionally propose that in commercial contracts an express fraud clause should be upheld, but only if it is written in clear unambiguous terms and specifically brought to the attention of the other party.

³² See Consultation Paper, paras 7.2 to 7.8.

³³ See Consultation Paper, paras 8.5 to 8.23.

- S.47 In consumer insurance, we propose that any term which purports to give the insurer greater rights in relation to fraudulent claims should be of no effect.³⁴

GROUP INSURANCE

- S.48 Group insurance is a common way to provide life insurance and other long-term benefits. As group members are not policyholders, they do not appear to be subject to the sanctions that apply to policyholders. Thus if a group member fraudulently exaggerates a loss, it appears that they would not forfeit the whole claim, but only the fraudulent element of the claim.
- S.49 We propose legislation to give insurers the same remedies against a group member as they would have against a policyholder. The group member who acts fraudulently would forfeit the whole benefit, and any subsequent benefit, and would be liable to pay the insurer's reasonable costs of investigating the fraud. However, fraud by one group member would not affect benefits to other members.³⁵

CO-INSURANCE

- S.50 Where two or more people take out insurance jointly to protect their property, the law usually treats them as acting together. Thus fraud by one party may result in forfeiture of the other party's share. Where the parties have become estranged, this could lead to harsh results. For example, if one spouse set fire to the marital home, the innocent party could lose their entire claim. This scenario has arisen in other jurisdictions, but has not been faced by the English and Scottish courts.
- S.51 In Issues Paper 7, we proposed legislation to protect an innocent joint policyholder who could prove that a wrongful act was carried out without their knowledge. Although consultees generally supported our proposal in principle, many thought that it was impractical.
- S.52 We have provisionally concluded that the problem does not require a legislative solution. We have not found evidence that joint policies are a problem in practice.³⁶ Any legislation would need to deal with complex issues of proof and valuation, and may prove a blunt way of dealing with the sensitivities involved. Furthermore, we think the courts could adapt the current law to do justice in the case, by (for example) construing the policy as a "composite" policy.
- S.53 If consultees have evidence that there is a problem in this area, we would welcome details.³⁷

³⁴ See Consultation Paper, paras 8.24 to 8.30.

³⁵ See Consultation Paper, paras 9.23 to 9.30.

³⁶ We found only one such case in the Financial Ombudsman Service records.

³⁷ See Consultation Paper, paras 9.2 to 9.22.

INSURABLE INTEREST

- S.54 Insurance differs from any other risk-transfer contract, such as gambling, because it is used to compensate for loss. For insurance to be valid, the insured must possess an “insurable interest”.
- S.55 The requirement may be imposed by a mix of contract, statute and the common law, but for some types of insurance it is unclear how the requirement is imposed. The English law of insurable interest has been described as “a confusing and illogical mess”.³⁸ Scots law is more straightforward,³⁹ but still contains anachronisms and anomalies.
- S.56 Insurance is conventionally divided into two categories, although the distinction is not clear cut. “Indemnity insurance” indemnifies the policyholder against actual loss, and includes buildings, goods and liability insurance. By contrast, life insurance (together with critical illness or personal accident insurance) pays out on the occurrence of a defined event. We use the term “life insurance” to include all this second category.

INDEMNITY INSURANCE

- S.57 In Issues Paper 4 we asked whether the doctrine of insurable interest had a role to play in indemnity insurance. Most respondents thought that it did, arguing that it fulfilled four functions:
- (1) It is a hallmark of insurance, distinguishing insurance from gambling.
 - (2) It enforces market discipline, ensuring efficient underwriting procedures.
 - (3) It forms a barrier against invalid claims.
 - (4) It helps to define both insurance, and where insurance is located, for tax and regulatory purposes.⁴⁰

Our proposals

- S.58 We propose to retain the doctrine, but to re-state it in a clearer form. At present, it is based on a bewildering array of common law and statute. Our proposals would:
- (1) provide a clear statutory basis for the requirement of insurable interest;
 - (2) repeal two outdated statutes: the Marine Insurance Act 1788 and the Marine Insurance (Gambling Policies) Act 1909;
 - (3) clarify that the insured must have an insurable interest at the time of loss;

³⁸ Robert Merkin, *Reforming Insurance Law: is there a case for reverse transportation?* p 78.

³⁹ In Scotland, the requirement for insurable interest is imposed by common law: see Bell’s Principles, s 457.

⁴⁰ See Consultation Paper, paras 12.2 to 12.35.

- (4) provide that a policy is void unless there is a real probability that a party would acquire some form of insurable interest at some stage.⁴¹
- S.59 For the definition of insurable interest in indemnity insurance we seek views on two options. The first is to leave the definition entirely to the courts. The second is to provide a non-exhaustive list, based on the current case law.⁴²
- S.60 For marine insurance, insurable interest is defined in the Marine Insurance Act 1906 (sections 4 to 15). We have been told that these provisions operate well, and we propose to leave them as they are.

LIFE INSURANCE: PROBLEMS WITH THE CURRENT LAW

- S.61 For life insurance the law is unduly restrictive. People may insure their own life and that of their spouse⁴³ for an unlimited amount. This is said to be based on “natural affection”. But the class is limited: one cannot insure the life of a cohabitant, a child or parent on this basis.
- S.62 Alternatively, policies may be based on the fact that the insured will suffer financial loss on another’s death, but this is restricted to “a pecuniary loss recognised by law”. It requires a legal right to payment rather than just a reasonable expectation of loss.
- S.63 The courts have taken a strict approach: a father’s expectation that his son would care for him or maintain him was held not to constitute an insurable interest in the son’s life.⁴⁴ Similarly, a case from 1904 found that burial insurance was invalid because a son had no legal obligation to bury his mother.⁴⁵
- S.64 Under section 3 of the Life Assurance Act 1774, any recovery is limited to the value of the insurable interest at the time of the contract. Again, this has been interpreted strictly: thus “key employee” insurance is limited to the costs of the notice period and replacement,⁴⁶ and many not include other loss to the employer on the employee’s death.
- S.65 It is common for life insurance policies to be written which go beyond those permitted under the current case law. Insurers frequently write “key employee” insurance for sums which exceed the notice period. Furthermore, travel insurance often includes a fixed sum on the death or injury of a child. As noted in a leading textbook, “insurance practice is becoming increasingly impatient” with the rigidity of the current law.⁴⁷

⁴¹ See Consultation Paper, paras 12.36 to 12.59.

⁴² See Consultation Paper, paras 12.60 to 12.69.

⁴³ The term “spouse” refers to a husband, wife or civil partner.

⁴⁴ *Halford v Kymer* (1830) 10 B&C 724.

⁴⁵ *Harse v Pearl Life Assurance Co Ltd* [1904] 1 KB 558. For an account of the case law, see Consultation Paper, paras 11.70 to 11.93.

⁴⁶ *Simcock v Scottish Imperial Insurance Co* (1902) 10 SLT 286.

⁴⁷ *MacGillivray on Insurance Law*, (11th ed 2008), at para 1-049.

- S.66 Without an insurable interest, life insurance is not only void, but illegal. This means that the policyholder is not entitled to the return of premiums paid.⁴⁸

LIFE INSURANCE: PROPOSALS FOR REFORM

- S.67 We propose a new statutory requirement for insurable interest to replace the outdated Life Assurance Act 1774. This would provide that without insurable interest, a policy is void but not illegal.⁴⁹

Widening the test: economic dependency

- S.68 Our main proposal is to widen the test of economic dependency. At present, the law requires a legal obligation. We propose a factual test instead: it should be sufficient if there is a real probability that the proposer will retain an economic benefit on the preservation of the life insured, or incur an economic loss on the death. This would enable people to insure the lives of family members where they are dependent on them and would suffer a loss if they died.
- S.69 The more difficult issue is whether the insured amount should be limited to the likely loss. Such valuations are inevitably subjective but the principle of insurable interest suggests that there should be some link. We ask whether the amount of the insurance must be reasonable, given the likely loss that the proposer will suffer.⁵⁰

Children under 18

- S.70 Several consultees argued that parents should be entitled to insure the lives of children under 18 for a small amount: a cap of around £30,000 was suggested. These products already exist and we agree that they should be regularised.
- S.71 We propose that parents should be entitled to take out insurance on the life of a child under 18. We ask if there should be a cap on the amount, and if so, what it should be.⁵¹

Cohabitants

- S.72 The proposed wider test for economic interest should enable most cohabitants to insure each others' lives. There was, however, significant support for permitting long term cohabitants to insure each other's lives without having to show an economic loss, provided a suitable definition could be found. This would make the application process easier.

⁴⁸ *Harse v Pearl Life Assurance Co Ltd* [1904] 1 KB 558. See Consultation Paper, para 11.38.

⁴⁹ See Consultation Paper, paras 13.111 to 13.116.

⁵⁰ See Consultation Paper, paras 13.66 to 13.75.

⁵¹ See Consultation Paper, paras 13.77 to 13.86.

S.73 We propose that cohabitants should be entitled to insure each other's lives without evidence of economic loss if they have lived in the same household as husband and wife or as civil partners for the whole of five years before the policy is taken out.⁵²

Group schemes

S.74 It is common for the trustees of pension schemes to insure the lives of their members, though the legal basis for doing so is unclear. We propose that the trustees of pension or group schemes should have an unlimited insurable interest in the lives insured.

S.75 We also ask whether in employer-sponsored group schemes offering employee benefits, an employer should also have an unlimited interest in the lives insured.⁵³

Repealing section 2 of the Life Assurance Act 1774

S.76 This requires the name of the person who benefits from life insurance to be inserted into the policy. If not, the policy may be avoided, which is a wholly inappropriate sanction. We propose that section 2 should be repealed.⁵⁴

⁵² See Consultation Paper, paras 13.87 to 13.103.

⁵³ See Consultation Paper, paras 13.104 to 13.107.

⁵⁴ See Consultation Paper, paras 13.108 to 13.110.

POLICIES AND PREMIUMS IN MARINE INSURANCE

- S.77 In 2006, we were asked to consider three provisions of the Marine Insurance Act 1906 which appeared outdated and problematic. These are: the requirement for a formal marine policy in section 22; the broker's liability for premiums in section 53(1); and the broker's lien in section 53(2). They apply only to marine insurance.

THE REQUIREMENT FOR A FORMAL MARINE POLICY

The problem

- S.78 Under section 22 of the Marine Insurance Act 1906, a contract for marine insurance is inadmissible in evidence unless "embodied in a marine policy". This introduces a technicality with potentially drastic consequences. It means that, without a marine policy, the insured cannot prove the existence of a contract, and therefore cannot establish its right to make a claim.
- S.79 The requirement dates from 1795, when stamp duty was imposed on marine insurance. It was a way of preventing tax evasion. As this form of stamp duty was repealed in 1970, the rationale behind the requirement has now disappeared.
- S.80 In Issues Paper 9, we commented that section 22 appeared to have little effect in practice, but it was difficult to defend its continued existence. It was damaging to have a law which was widely ignored and difficult to justify to an international audience. We received nine responses, of which seven agreed that the section should be repealed.⁵⁵

Our proposal

- S.81 We do not think that the statute should require marine insurance to be in any particular form. Although it is clearly desirable to put contract terms in writing, this should be a matter for the industry (backed if necessary by regulation). We propose to repeal section 22.⁵⁶
- S.82 Removing the requirement for a formal policy has implications for eight other provisions of the 1906 Act. We consider these in detail in Part 16. In Part 17 we propose to repeal five of these provisions and reform another three.

THE BROKER'S LIABILITY FOR PREMIUMS

- S.83 Section 53(1) of the Marine Insurance Act 1906 states that "where a marine policy is effected on behalf of an assured by a broker, the broker is directly responsible to the insurer for the premium". In other words, the broker is primarily liable to pay the premium, not the policyholder. In Issues Paper 8, we described this provision as anomalous, counter-intuitive and uncertain. It needs to be understood in the light of its common law background.

⁵⁵ See Consultation Paper, paras 15.26 to 15.40.

⁵⁶ See Consultation Paper, paras 17.1 to 17.7.

S.84 The section becomes important in two circumstances: where the policyholder is insolvent and where the broker is insolvent.

Where the policyholder is insolvent

S.85 Section 53(1) makes the broker liable to pay the premium to the insurer, even if the insured refuses to pay or becomes insolvent. Insurers told us that they do occasionally invoke section 53(1) against brokers. While other methods of securing payment would be relied on in the first instance, section 53(1) provided insurers with a “useful additional protection”.⁵⁷

S.86 That said, the section is widely misunderstood. From the insurer’s point of view, the section has three limitations:

- (1) It only applies to marine insurance;
- (2) It may not cover adjusted premium clauses; and
- (3) It is uncertain whether it applies to insurance contracts written under foreign law.⁵⁸

S.87 From the broker’s point of view, it imposes a liability which is too difficult to escape. Although in theory the parties may contract out of the section, it is not easy. The section affects three parties; the insurer, the insured and the broker. To exclude its effects fully one would need three separate contracts, or one contract with three parties. Furthermore, the case law suggests that only a very clearly worded clause would suffice.⁵⁹

Where the broker is insolvent

S.88 There may be more to section 53(1) than meets the eye. It codifies nineteenth century case law which underlines that a marine policyholder is not liable to pay premiums to the insurer. Instead, the insurer claimed the premium from the broker, and the broker had a separate claim against the policyholder. The broker received the money not as an agent but as a principal, in its own right.

S.89 There is uncertainty about how far this is still the law. If it is, it may undermine statutory protection when a broker becomes insolvent. The Client Assets Sourcebook (CASS) rules in the FSA handbook are based on the idea that the broker holds the premium as an agent, either for the insurer or the insured. If the broker is paid as principal, then these rules would not apply.

S.90 If a marine broker were to become insolvent, insurers could face unexpected risks. It is likely that any money which policyholders had already paid would be held by the broker, for the benefit of its general creditors. Where policyholders had not paid, we think that the broker’s liquidator would be entitled to sue policyholders for the debts on behalf of the creditors as a whole.

⁵⁷ See Consultation Paper, para 18.11, quoting the International Underwriting Association.

⁵⁸ See Consultation Paper, paras 18.23 to 18.5.

⁵⁹ *Universo Insurance Co of Milan v Merchants Marine Insurance Co Ltd* [1897] 2 QB 93. See Consultation Paper, paras 18.72 to 18.76.

S.91 This imposes risks which are not widely understood in the market.⁶⁰

Proposals for reform

S.92 We think that section 53(1) poses unacceptable legal risks, and is in need of reform. We propose that:

- (1) Section 53(1) should be re-enacted in a way that does not preserve the common law underpinnings. The policyholder should be liable to pay premium to the insurer, and should pay the broker as agent. Any liability assumed by the broker should be in addition to the policyholder's liability, not a substitute.
- (2) The issue of whether the broker is liable to pay the premium to the insurer should be a matter of agreement between broker and insurer.
- (3) We consider what the default rule should be: should brokers be liable for paying premiums unless they contract out of liability, or only if they contract in? On balance, we suggest that marine brokers should be responsible unless they contract out. We invite views on this issue.⁶¹

THE BROKER'S LIEN

S.93 Section 53(2) provides the broker with a lien over a marine policy for unpaid premiums and charges. It permits the broker to retain not only the policy document but also any policy proceeds to discharge the policyholder's unpaid debts.

S.94 There is a problem with this section: it probably only applies where the broker has a paper policy document in its possession. As paper policies are rarely used, it may give brokers little protection.⁶²

S.95 We propose to replace section 53(2) with a new section which does not require a policy document. Where the broker has paid premium to the insurer following a legal obligation to do so, we propose that:

- (1) the broker should be entitled to exercise any right the insurer has to recover the debt from the policyholder;
- (2) the broker should also have a specific statutory right to set off any premium or commission against the proceeds on that policy;
- (3) Where no third party interests are involved, a broker should have a more general right to set off any money owed by the insured against any money held by the broker on behalf of that insured. We welcome views on how third party interests should be defined.⁶³

⁶⁰ See Consultation Paper, paras 18.27 to 18.71.

⁶¹ See Consultation Paper, paras 19.18 to 19.31.

⁶² See Consultation Paper, paras 20.2 to 20.25.

⁶³ See Consultation Paper, paras 20.26 to 20.33.