Insurance contract law reform in the UK

Paving the way for reform

The Law Commission and Scottish Law Commission are currently engaged in a wide ranging review of the law applicable to consumer and commercial insurance contracts. In January 2006, they issued a Scoping Paper, requesting views from lawyers, practitioners and industry organisations as to what aspects of the law should be included in the review. It was clear from the responses that there was widespread support for reform. There was a general desire to give a fairer deal to policyholders, not only on the part of consumer organisations, but also insurers wanting to drive up standards and improve the general reputation of the industry. There was also recognition that archaic and uncertain law was impeding the effective conduct of business and a concern that the current law may weaken the position of the UK should moves towards harmonisation of European insurance contract law become a reality.

As a result, the Commissions have implemented a root and branch review of insurance contract law in England, Wales and Scotland. As at 1 January 2008 they had produced three Issues Papers setting out their tentative proposals for reform to the law of misrepresentation, non-disclosure, warranties and agency in the context of pre-contract information, and one Consultation Paper setting out their formal proposals in these areas.

Issues Paper 1 – Misrepresentation and Non-Disclosure

In September 2006, the Commissions produced their first Issues Paper, dealing with misrepresentation and non-disclosure. This proposed sweeping reforms to the law; for example:

- The test of materiality would be based on what a *"reasonable insured"* (rather than a *"prudent underwriter"*) would understand to be material to the underwriter in question;
- Insurers would have no right to avoid or refuse to pay a claim where there had been innocent misrepresentation or non-disclosure; and
- In the case of negligent non-disclosure or misrepresentation, the law would apply a proportionate remedy by asking what the insurer would have done had it known the true facts.

Issues Paper 2 – Warranties

In November 2006, the Commissions produced their second Issues Paper, dealing with warranties. This proposed as follows:

- Basis of the contract clauses, which, in effect, convert every answer given by the insured into a warranty, should be of no effect;
- There should be a causal connection requirement, so that insurers would be able to deny claims where there was no causal link between the breach of warranty and the loss; and
- Breach of warranty would give insurers the right to terminate the contract, rather than being automatically discharged from liability.

Issues Paper 3 – Agency and Pre-Contract Information

The Commissions produced their third Issues Paper, on agency and pre-contract information, in March 2007. This proposed, amongst other things, that:

- Intermediaries should be regarded as the insurer's agent for the purpose of obtaining pre-contract information, unless they are genuinely searching the market on the insured's behalf;
- Intermediaries who are acting for the insurer should remain so when completing a proposal form (in contrast to the current law); and
- An insurer's remedy for non-disclosure on the part of an intermediaries should be damages rather than avoidance.

Consultation Paper 1

In June 2007, the Commissions set out their formal proposals in a Consultation Paper.

A key aspect of the proposals is the distinction made between consumer and business insurance, which is unique among the major European jurisdictions. It is proposed that the law relating to consumer insurance will be mandatory, so that the parties will not be free to contract out of the law unless the relevant terms are more favourable to the insured. However, for business insurance it is proposed a new default regime based on accepted good practice will apply. This means that, with certain formal safeguards, the parties will be free to agree a different set of a contractual rules; if they do not, they will be subject to the default rules.

Modifying businesses' duty to disclose: a new default rule

It is proposed that the duty on businesses to disclose information should be retained on the basis that it is part of the way the UK market works. However, the duty is currently very wide; the insured is required to disclose anything that it knows, or should know, in the ordinary course of business if it "*would influence the judgment of a prudent insurer in fixing the premium, or determining whether he will take the risk*" (s18(2) Marine Insurance Act 1906)). The Commission proposes that, in order to found a claim for non-disclosure, the insurer would have to show either:

- that a reasonable insured in the circumstances would have appreciated that the fact in question was one that the insurer would want to know; or

- that the proposer actually knew the fact was one that the insurer would want to know.

This is seen as a flexible test, which would adapt to the many different circumstances in which insurance is bought. In a sophisticated market, where both the insurer and insured are experts or professionally represented, almost no difference between the existing and the proposed law is to be expected. However, in the case of small businesses buying off-the-shelf products without professional help, the onus will be on the insurer to ask appropriate questions.

Misrepresentation: new default rules

It is proposed that to found a misrepresentation, the insurer would need to show that the business made a *misrepresentation* which *induced* the insurer to enter the contract and which a *reasonable person* in the circumstances would not have made.

The first two requirements exist in current law. The difference is that an insured who has acted honestly and reasonably would not lose cover, unless that is specifically agreed in the contract.

An insured will be found to act reasonably if it believed what it said was true, or if it answered a general question and reasonably did not appreciate what information was required. The test of reasonableness will depend on the type of market, whether the business received professional advice, and the clarity of the questions asked.

Remedies: should the law distinguish between dishonesty and negligence?

The proposals for consumer insurance distinguish between three types of misrepresentations: *"deliberate or reckless"* misrepresentations, where the policy could be avoided, *"reasonable"* misrepresentations, where the policyholder would be protected and *"negligent"* misrepresentations, where the insurer would be granted a compensatory remedy. However, the Commission has still not reached a conclusion as to whether there should be such a distinction in the business context and asks for views. In particular, it is interested in whether avoidance should be retained as the default remedy for negligence. There are a number of factors to take into account, for example the fact that it is difficult to prove that a corporate organisation acted dishonestly. Furthermore, it was proposed in the relevant Issues Paper that a so-called *"proportionate"* remedy could be made available, based on what an insurer would have done had they known the true facts. However, industry feedback suggests that this would be difficult to apply in practice to business insurance.

Contracting out of the default regime

Under these proposals, the parties would be free to agree different rules. For example, if the parties wished, they could agree that the insurer should have specified remedies, even for misrepresentations that were neither dishonest nor careless. The easiest way of agreeing different rules would be through a specific fact warranty. It is proposed that a warranty of this type would have the following effects, in the absence of an agreement to the contrary:

- Liability for the breach would remain *"strict"*. In other words, it would not matter whether the insured should have been aware of the true position; and

- If the fact warranted is not true, the insurer may refuse to pay the claim, provided that (a) the breach is material and (b) it had some connection to the loss.

If the parties wished to agree other consequences (such as avoidance for immaterial breaches), they would need to spell this out explicitly in the contract. However, the parties should not be allowed to convert all the answers on a proposal form into warranties en bloc, as in a basis of the contract clause. The contract would need to specify which facts were to be given warranty status.

There would also be controls on contracting-out of the default regime when dealing on the insurer's standard terms.

Small businesses

Although in the Issues Papers the Commission suggested separate regimes for small businesses, it now thinks that the proposed default regime, coupled with the controls on standard term contracts, would be sufficient to protect the interests of vulnerable small businesses. However, views are sought on whether greater protection is needed.

Warranties in business insurance

It is proposed that for businesses the following rules should apply to warranties:

- A warranty should be set out in writing;
- A business should be entitled to be paid a claim if it can prove on the balance of probabilities that the event or circumstances constituting the breach did not contribute to the loss. However, unlike for consumer insurance, this would be a default rule; and
- A breach of warranty would not automatically discharge the insurer from liability, but would instead give the insurer the right to terminate cover for the future.

Intermediaries and pre-contract information

It is provisionally proposed that an intermediary should be regarded as acting for the insurer unless they are clearly independent of the insurer and acting on the insured's behalf. However, where an intermediary would normally be regarded as acting for the insurer in obtaining pre-contract information, they should remain the insurer's agent while completing a proposal form.

Section 19(a) of the Marine Insurance Act 1906 provides that an agent placing insurance must disclose every material circumstance that it knows, even if the insured does not know it. If the agent fails to do so, the insurer may avoid the policy against the insured, even though the insured is innocent of wrongdoing. For business insurance, the Commission proposes that breach would give the insurer a right in damages against an intermediary, rather than the right to avoid the policy.

Responses

Industry responses were due by November 2007. The Commissions are currently working on a summary of the results, which they anticipate being published in April 2008.

The next steps

As at 1 January 2008, the Commissions are due to publish their fourth Issues Paper, dealing with insurable interest. This will be the first in a series of papers to be produced in advance of the second formal Consultation Paper. The next will deal concentrate on matters of post-contractual good faith.

If all goes to plan, the Commissions will produce a draft Bill in 2010.