THE WAY FORWARD FOR UK INSURANCE LAW (Part I)

Rob Merkin

1 THE PROCESS

In January 2006 the English and Scottish Law Commissions launched a second, joint, investigation into the law of insurance, the first having taken place in 1980 but having produced no legislative consequences. After an initial scoping exercise to determine the views of interested parties as to the areas of investigation, the Law Commissions focused in the initial stage of its inquiry into utmost good faith and breach of warranty. Three issues papers were published in 2006 and 2007, and after consultation, a consolidated paper, *Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured*, appeared in July 2007. It is available online at http://www.lawcom.gov.uk/docs/cp182_web.pdf. This document has made a series of important recommendations for changes to the law. The underlying purposes of the recommendations are: the reaching of a fair balance between the interests of insurers and policyholders, whereby policies meet reasonable expectations of policyholders without imposing undue costs on insurers; and the development of a system of rules which are coherent, clear and readily understandable. All of this would be in particular very familiar to an Australian audience, which went through the same process in 1978 to 1982 under the guidance of Kirby J. Subsequently, in January 2008, the Law Commission published a fourth issues paper, on insurable interest. The significance of the Australian experience was not lost on the Law Commissions, which dispatched the present commentator to Australia in October 2006 to investigate what lessons were to be learned. The resulting report is on the Law Commission's website, http://www.lawcom.gov.uk/docs/merkin_report.pdf. The Australian 1984 Act does not of course apply to marine insurance or to reinsurance, but the UK changes proposals encompass these matters. If the law is changed, those changes will have profound effects on all common law and other jurisdictions which retain a version of the Marine Insurance Act 1906.

2 GUIDING PRINCIPLES

Basic distinction between consumers and businesses

The 2007 Consultation Paper recommends the drawing of a distinction between retail customers and business customers. A retail customer for this purpose is an individual acting for purposes which are outside his trade, business or profession, a definition derived from the Directive on Distance Marketing of Consumer Financial Services, European Parliament and Council Directive 2002/65/EC, art 2(d), which refers to "any natural person who is acting for purposes which are outside his trade, business or profession". This itself was taken from the Unfair Terms in Consumer Contracts Directive, European Parliament and Council (Directive 93/13/EEC, art 2(b)). In the case of a retail policy the Law Commissions have proposed mandatory rules which mitigate the effects of the present law. In the case of business policies of all types, including policies taken out by small businesses, marine insurance and reinsurance, there are to be default rules which the parties are free to vary by contract subject to controls on standard terms which defeat the assured's reasonable expectations. The distinction between a retail and business policy may be difficult at the margins, and the Law Commissions have proposed a predominant purpose

test: “Thus a self-employed driver who uses a car mainly as a taxi, with only the occasional private trip, would be considered to be insuring it for business purposes. However, an individual who insures their home for £30,000, including a small office containing £3,000 of business equipment, would be a consumer.” The Law Commissions have left open for consultation whether: (a) the consumer regime should apply to specific high-value items (yachts, etc); and (b) small businesses should be given greater protection.

The need for legislation

The Law Commissions have recognised a large number of merits of the Financial Ombudsman Scheme, which parallels the Australian Ombudsman scheme: there is a general “fair and reasonable” approach; the service is free; remedies are flexible and not necessarily available to the courts; an Ombudsman decision is binding on the insurers but not on the assured, so using the Scheme cannot harm the policyholder; the process is speedy; the procedure is inquisitorial rather than adversarial; the Service is accessible to complainants; and the procedures are informal and enable consideration of evidence which may be inadmissible in the courts. All of that said, the Law Commissions are of the view that legislation is needed in order to avoid what might be regarded as arbitrary decision-making.

3 UTMOST GOOD FAITH AND CONSUMERS

The duty of disclosure

The Law Commissions have recommended the abolition of the duty of disclosure in consumer cases, for both new contracts and renewals. The principle is that “Insurers should ask questions about what they want to know; consumers should not be expected to give information that has not been asked for.” This recommendation rejects the 1980 proposal that the duty of disclosure should be retained: the current Law Commissions have rejected the earlier suggestion that abolition might lead to “sharp practice”, might prevent the grant of temporary cover and would necessitate an impossible distinction between consumer and business insurance. The Law Commissions’ present view is that the market has now changed and that disclosure has little part to play, particularly given the widespread use of internet selling. The onus is thus to be cast on insurers to ask appropriate questions. The possibility that the assured may be aware of facts which insurers might have no reason to suspect exist (eg, threats to property) is to be countered by permitting insurers to ask a general “sweeper” question asking about other relevant facts: the consumer’s only duty faced with a sweeper question is to give such specific information that a reasonable consumer would understand that the question was intended to elicit. The Law Commissions have specifically rejected the Australian approach, set out in s 21A of the Insurance Contracts 1984, under which failure to ask a specific question waives disclosure under a general question. The section is all but incomprehensible and is shortly to be amended.

The emphasis of the proposed new regime is, therefore, misrepresentation. Under the proposals, the insurers will not have any remedy against the assured if: (a) any question was answered honestly and carefully; or (b) the assured did not appreciate that his answer was relevant to the

insurers; or (c) the insurers were not induced to enter into the policy by reason of the assured's answers. This approach abolishes the existing "prudent insurer" test of materiality and replaces it with a "prudent assured" test which focuses on what a reasonable consumer would have thought to be relevant to the insurers in question. The Law Commissions have not sought to define 'misrepresentation' but have left this to the common law. Contrast the Insurance Contracts Act 1984, which states that: ambiguous questions are to be construed as they would be understood by a reasonable person (section 23); a statement of belief reasonably held is not misrepresentation (section 26); and failure to answer a question is not misrepresentation (section 27). English law accords with the first two but not the last of these propositions.

Remedies

Assuming that the assured has made a false statement to the insurers, and that the statement has had an inducing effect, the remedies open to the insurers depend upon the assured's state of mind.

If the assured has acted honestly and reasonably, the insurers have no remedy. As far as honesty is concerned, the principle is that "A consumer assured who was both honest and careful in giving pre-contract information should not have a claim turned down on the basis that the information was incorrect or incomplete." Reasonableness refers to the assured's knowledge of the relevance of the information to the insurers. The Law Commissions have recommended that the test of reasonableness should be objective, in that it turns upon an objective reasonable assured rather than a subjective notional person in the assured's actual position. The objective test is, however, modified by considerations such as the type of policy, the normal characteristics of the sort of policyholders likely to purchase the policy and the way the policy was advertised and sold. The court is also to take account of particular characteristics of the assured which were actually known to the insurers. The Law Commissions have, however, rejected the suggestion that there should be a specific provision in the legislation that insurers should be under a duty to gather information for themselves, so that they are not deemed to know the content of medical reports, databases and even the contents of their own files. Instead, in asking whether the assured acted reasonably, the extent to which the assured could have assumed that the insurers would have the information themselves is to be taken into account. The burden of proving that the assured acted unreasonably is cast on the insurers. In Australia the Insurance Contracts Act 1984 has been interpreted as laying down a rigid objective test. The 2007 Treasury Review of the Act felt that the test was too strict as it applied to consumers, and has recommended modification along the lines of the Law Commissions' proposals.

If the assured has acted fraudulently, in that he has given false answers deliberately or recklessly and is or ought to have been aware that the answers were relevant to the insurers, the policy may be avoided as under the existing law. The Law Commissions are undecided as to whether the premium should be refunded on avoidance. The principle is expressed thus: "In our view, an insurer should be entitled to avoid the policy if the proposer has made a deliberate or reckless misrepresentation, that is, if they make a representation which they both: (1) know to be untrue (or know may be untrue, and make nonetheless, not caring whether or not it is true); and (2) know to be relevant to the insurer (or know may be relevant and do not care whether or not it is relevant)." The assured's motive is irrelevant, and the relevance test is not one of decisive effect but one of whether the assured knew or ought to have known that the matter would be taken into

account by the insurers. There is to be a presumption that an express question is relevant, so that in practice a deliberate or reckless false answer is likely to be enough to justify avoidance. The Law Commissions are undecided whether the premium should be forfeited. There is forfeiture in Australia. Under section 31 of the 1984 Act the Australian courts have a discretion to refuse avoidance in the case of fraud, where avoidance would be harsh and unfair and a lesser remedy of damages would be just and equitable. The Law Commissions have specifically rejected this proposition.

If the assured has simply been negligent, in that he has given a false answer which he either ought to have known was false or ought to have known was relevant, then there is no fixed remedy. Instead, the law is to aim to put the insurers into the position they would have been in had there been a truthful answer. The principle is that: "A consumer who was honest in giving pre-contract information, but less careful than they should have been, should not automatically lose their claim. The outcome should depend on what the insurer would have done had it known the true situation." The remedy of avoidance is not automatically available. In its place there is a monetary remedy: (i) if the insurers would have charged additional premium without misrepresentation, the amount of the claim is reduced in proportion to degree of underinsurance; (ii) if the insurers would have excluded a particular risk, the claim not payable if it would have fallen within the exclusion; and (iii) if insurers would have declined the risk, the policy is to be avoided and premiums returned, although possibly subject to an exception giving the court the discretion to refuse avoidance where other insurers would have accepted the risk either at the same or on a slightly greater premium. The 2007 proposals, unlike those in 1980, have embraced proportionality, and have rejected the suggestion that the calculation of the premium that would have been charged is not practicable. In putting forward these suggestions, the Law Commissions have rejected the approach put to it that a claim should be payable unless the information not stated was causally linked to the loss. Proportionality has been rejected in Australia, in favour of the principle that the insurers are entitled to recover only the additional premium that would have been charged and may not reduce the amount of the claim proportionately. The only situation in which proportionality has been accepted is in the context of age misrepresentations in life policies: see section 30 of the 1984 Act.

In more general terms, the approach is to be contrasted to that in Australia, where honest and negligent assureds are treated in the same way, under section 28(3) of the 1984 Act. The Law Commissions' proposals are far more generous to assureds in this regard. Due to drafting oversights in the 1984 Act, the power of the court to grant relief to a negligent assured does not at present exist, but the 2007 Treasury Review has recommended that it should. The Law Commissions have not proposed conferring any statutory right of cancellation by notice on insurers. Contrast the Insurance Contracts Act 1984, sections 59 and 60.

Life insurance

The Law Commissions have suggested a possible modification of the above rules for consumer life policies. After five years, the policy would, other than in the case of fraud, become incontestable and insurers would therefore lose all remedies for negligent misrepresentation at the end of that period. The proposal has met a good deal of opposition, on the grounds that it would tip the balance too far in favour of the assured and might increase costs and premiums. In its

favour, the Law Commissions have commented that the proposal would increase trust in the market and would also discourage churning within the industry. The proposal is based on the Insurance Contracts Act 1984, section 28, which lays down a three-year period after which a life policy is rendered incontestable

Duration of assured's duty

The Law Commissions have recommended that the existing law on the duty of the assured's duty should be maintained in modified form. The present position is that the assured is required to correct any false statements should matters change between the assured's presentation of the risk and the acceptance of the proposal by the insurers: that is to remain the case, but with the additional requirement for insurers to warn the assured of that duty. However, as is presently the case, there is no duty to correct facts which have changed after the inception of the risk. Insofar as there is an express duty on the assured to forward post-contract information to the insurers, that obligation is in any event governed by the Unfair Terms in Consumer Contracts Regulations 1999.

4 UTMOST GOOD FAITH AND BUSINESSES

Existence of duty

The Law Commissions have recommended that the duty of disclosure should be maintained for business insurance. Their reasons are as follows. First, the duty of disclosure has become part of the way the UK business insurance market works. For many business policies, there is no proposal form. Instead the broker presents the risk, and the underwriter relies on the broker and client to present that risk honestly. While it would be possible to distinguish insurance that was preceded by a proposal form and insurance where there was no such form, and require disclosure only in the latter, the distinction would cause difficulties in marginal cases. Secondly, business insurance involves a much greater variety of unusual risks than consumer insurance, so that it is a more difficult task for insurers to ask the appropriate questions. Thirdly, a greater proportion of business insurance is conducted through brokers, who can advise on the information required. Finally, if the consumer approach was adopted and the insurers were required to ask specific questions with a general sweeper question, the express questions could simply be an empty formalism while the general question would have the effect of re-imposing the duty of disclosure. The recommendation is, therefore, that the duty is to remain, but not coupled with any duty on insurers to warn of its existence. Contrast the warning required by section 22 of the Insurance Contracts Act 1984. The 2007 Treasury Review proposes that the warning be amended to point out that the duty of disclosure lasts until the making of the policy. Such a warning might also be appropriate for the UK reforms, given that the Law Commissions have accepted that any change in circumstances between the negotiations and the making of the contract has to be brought to the insurers' attention. Businesses would of course also be subject to the duty not to make false statements.

Scope of the duty of disclosure

The Law Commissions' approach to the duty of disclosure in business cases is to modify the law by replacing the existing prudent underwriter test with a prudent assured test. Accordingly, a fact will have to be disclosed if: (a) the assured was aware of it; and (b) the assured knew or ought to have known that it was relevant to the insurers. It will, however, be open to the parties to modify these tests by express agreement, in favour of either party, although any term which imposes a more onerous duty has to meet the assured's reasonable expectations. The reasonable expectations test would permit standard terms to operate only if brought to the assured's attention. The approach is threefold: did the assured contract on the insurers' written standard terms of business; did one of the standard terms purport to give the insurers greater rights than the default regime to refuse claims on the basis of the assured's failure to provide accurate pre-contract information; and, if so, did the term defeat the assured's reasonable expectations?

As to the assured's knowledge of the fact, the Law Commissions have recommended that the test should be that a fact is to be disclosed if the assured knew or ought to have known of it, with the burden of proof of knowledge resting on the insurers. The test is whether the assured had acted reasonably. On the face of things this is a more onerous test than that presently laid down, which refers to a fact which the assured either knew or in the ordinary course of business ought to have known, which has been held to set out a "blind eye" test of knowledge. However, in practice, in business cases the outcome is likely to be the same.

As to the assured's knowledge of materiality, the test is to be that "The business insured should only be required to give such information as a reasonable insured in the circumstances would appreciate was relevant to the insurer."The prudent assured test is therefore the default test, and allows the court to take into account size and sophistication of assured and whether or not a broker was used. The broker's appreciation of the materiality of facts will on this approach defeat any defence by the assured that it was unaware of materiality.

Remedies for non-disclosure and misrepresentation

The remedies available to insurers in business cases are based on those which apply in consumer cases, but with some uncertainty on the position where the assured has merely been negligent. The basic principle is that the insurers have no remedy unless they can show that inducement, in that they would not have entered into the contract at all or on the same terms, and that the assured knew or ought to have known of the fact and of its relevance.

In the case of a business assured who was both honest and careful in giving pre-contract information, there is to be no right of avoidance and no right for the claim to be rejected, subject to agreement to the contrary.

In the case of dishonesty, where the assured knew of the fact and of its relevance, there is to be a right of avoidance.

The difficult situation is that of negligence. The Law Commissions are uncertain whether the consumer rules should apply to negligence, so that the insurers are entitled to a monetary remedy based on their actual loss, or whether the law should treat dishonesty and negligence in the same

way. The Law Commissions have invited comments on this point, but provisionally favour treating fraud and negligence in the same way, based on (a) the difficulty of proving dishonesty, (b) the difficulty of showing how insurers would have reacted had they been told the truth and (c) the need to encourage assureds to act carefully. Quite why these points are more difficult to prove in business insurance than in consumer insurance is not adequately explained by the Law Commissions. The Law Commissions are also unsure: (1) whether the discretion to refuse avoidance, available in consumer cases involving negligence, should also apply in business insurance (in direct contrast to the Australian Treasury proposals); and (2) if there is no right of avoidance for negligence, whether insurers should have the right to cancel the policy having paid the claim.

5 PARTICULAR CASES

Group life insurance

Group insurance policies taken out by employers for the benefit of their employees provide a variety of insurance benefits, including income protection, medical expenses, critical illness cover and death benefits. Such a policy will typically be in declaration form, with a master policy being issued to the employer and individual employees being declared to the policy as separate risks. In the event that a false presentation is made in respect of an employee, the insurers have the right to refuse to pay him, but the rights of other employees remain unaffected. The Law Commissions have tentatively proposed that the group policy itself is a commercial contract which is subject to the business rules so that if there is misrepresentation by the policy as a whole the insurers may exercise their usual rights, whereas the individual benefits conferred upon an employee are consumer in nature so that any false statement made by or on behalf of an employee affects his rights only and the insurers' remedies are to be assessed in accordance with the consumer rules.

Life of another policies

It is common practice for life policies to be issued to party A on the life of party B., both in the domestic and business contexts: key-man insurance is a good example of the latter. Some policies are issued jointly to A and B, with the benefits payable to the survivor. Even though A is the proposer, insurers may seek information from B as the life assured, and the Law Commissions have proposed that information provided by B is to be treated as if provided by A, so that if B has deliberately misstated a relevant fact then the insurers would have the right to avoid A's policy. The law at the moment is, at least in the absence of express provision as to the consequences of breach of duty by A, unclear. The Law Commissions are recommending a similar regime for joint names survivor policies, in that breach of duty by either assured gives the insurers the appropriate remedies against the survivor.

Co-insurance

The Law Commissions are not recommending any change in the law as it affects co-assureds. Accordingly, if the policy is joint (in that the parties have the same interest in the insured subject

matter) then any breach of duty by one c-assured affects the rights of both. By contrast, if the policy is composite, in that the parties have insured their different interests separately, breach of duty by one co-assured does not affect the other.

6 THE ROLE OF BROKERS

Under the present law, the broker is the agent of the assured when presenting the risk to the insurers. The broker is under an independent duty under section 19 of the Marine Insurance Act 1906 to: (a) disclose facts known to him; and (b) disclose facts which are known to the assured and which ought to have been communicated to the broker. The Law Commissions are contemplating the abolition of section 19(b) in consumer cases, so that the assured would be protected if he communicated information to the broker which was not passed on to the insurers. Alternatively, if the provision is maintained, the Law Commissions are suggesting that the assured should be protected but that the insurers would have a cause of action for damages against the brokers. This comes close to transferring the agency of the broker from the assured to the insurers in consumer cases. The Law Commissions have, however, rejected taking that step as such, but have merely provided for a limited exception in consumer cases

As far as section 19(a) is concerned, the difficulty here is that information known to the broker but not to the assured must be disclosed to the insurers, failing which the insurers have a remedy against the assured (at the moment, avoidance) but not against the broker (the duty of utmost good faith not giving rise to damages). The Law Commissions do not regard it as appropriate that there should be avoidance against a wholly innocent assured, and has pointed out various problems with section 19(a): does it apply to intermediate brokers or just to placing brokers; does it apply to all information or just to information which the broker has acquired while acting as agent for the assured; does the duty apply to policies not governed by English law; and how can it be reconciled with rules on confidentiality as between the broker and a third party? The Law Commissions are provisionally of the view that the subsection should no longer apply in consumer cases, or that if it does apply then the remedy should be in damages in favour of the underwriter against the broker. If the subsection is retained, the Law Commissions have asked for comments on the outstanding queries relating to it.

7 REFORM OF THE LAW OF WARRANTIES

Background

The state of the law of warranties in England has attracted widespread criticism judicial and academic criticism. The possibility of law reform was considered by the Law Commission in its 1980 Report, the recommendations of which may be summarised as follows:

(1) A term of a contract of insurance should not be capable of being a warranty unless it is material to the risk, though a term which would at common law have been a warranty should be presumed material, subject to the assured's right to rebut this presumption by showing that the clause is not in fact material.

(2) If a term is to become a warranty, the insurer must, within a reasonable time of the giving of the warranty, provide the assured with a written copy of the warranty. Failure to comply would preclude the insurer from relying on any breach of the warranty.

(3) The right to repudiate for breach of warranty should remain, but the right to reject liability for a loss which has already occurred should be limited to cases where the warranty was intended to guard against the risk of loss of the type which occurred, and the assured's conduct has made the materialisation of such loss more likely. In other cases the insurer should be entitled to repudiate the policy prospectively.

(4) The right to terminate for breach should take effect only from the date when a written notice of repudiation is served on the assured; it should not be retrospective to the breach itself.

The English and Scottish Law Commissions, in their 2007 Consultation Paper, have echoed the criticisms of the law and have issued recommendations which are more far-reaching than those published in 1980 and in particular which encompass marine warranties. The proposals are as follows.

Warranties of existing fact

The Law Commissions have confirmed that it should no longer be possible for insurers to create blanket warranties of existing fact by the use of basis and equivalent clauses. The recommendation is that such clauses should no longer be of effect. The validity of individual warranties of fact depends upon whether the policy is consumer or business in nature.

In the case of a consumer policy, the recommendation is to go further than the 1980 proposals and to render warranties of fact ineffective. Any representation made by a consumer is to be treated as a representation rather than a warranty, which means that the rights of the insurers are those which apply to misrepresentation. This is a direct steal from section 24 of the Insurance Contracts Act 1984. The remedies for misrepresentation were outlined above in the context of the reform of the law of utmost good faith, but in outline insurers have remedies only against an assured who failed to act honestly and reasonably, and there can be avoidance only against an assured who was dishonest and whose false statement induced the insurers to enter into the contract.

In the case of a business policy, individual warranties of fact are to be permitted. However, unless the policy otherwise provides (as is to be permissible under the proposals) the insurers will have the right to rely upon a breach of warranty only if the breach has some connection with the loss: under this default rule the assured will have the right to recover if the warranty was not material to the risk and the assured can prove that the breach did not cause or contribute to the loss. Any warranty must be set out in writing, although it need not be specifically drawn to the assured's attention in order to be valid. The use of the word "warranty" is sufficient to create a term which gives rise to strict liability and which therefore ousts the default requirements of materiality and causal link. It is not clear why the Law Commissions have chosen to confine their adoption of section 24 to consumer policies, other than perhaps the doctrinal approach that the market should govern commercial relationships. The approach is far from free from criticism. Clauses which

give rise to 'strict liability' irrespective of the assured's state of mind are draconian in all contexts. In the business market the proposals can only create disputes as to whether proper notice was given, whether the necessary causal link exists and whether – by reference to the 'reasonable expectations' test – the parties have or have not validly contracted out of the default position.

Future warranties

The Law Commissions have identified three objections to the present law which allows an insurer to treat itself as automatically discharged from liability on breach of warranty: the breach may be immaterial to the risk; the breach may be unconnected with the loss; and the insurer can rely upon a breach even though it has been remedied by the date of the loss.

The basic proposal, which applies to consumer and business policies alike, is that a breach of warranty unconnected with a loss should not give the insurers a defence. A defence is available only if the breach caused or contributed to the loss: the "contributed to" test is more favourable to insurers than the "caused by" test alone, and in this regard the Law Commissions have preferred the New Zealand rather than Australian approach to causation in section 54(3) of the 1984 Act. The burden is on the assured to prove absence of causation. The Law Commissions have also chosen to adopt the Australian principle that if a breach caused contributed to only a part of the loss, the insurers should be required to pay for loss that was unrelated to the breach (see section 54(4) of the 1984 Act). There are nevertheless some differences between consumer and business cases.

In a consumer case, the rules on continuing warranties are mandatory. Further any remedy for breach of warranty is to be available only if the warranty was set out in writing in the policy or some other document supplied to the assured and sets out exactly what is required of the assured in order to comply.

As far as business insurance is concerned, there are two variations. The first is that the default rules can be ousted, so the parties are free to agree that the insurers are to have remedies for breach of warranty even in the absence of any causal link between breach and loss. The safeguard for the assured is that if this principle is set out in the insurers' standard terms and conditions, the clause is operative only if it does not defeat the assured's reasonable expectations. The second is that the assured must be given notice of the warranty in either the policy or an accompanying document but that there is no need for the assured's obligations to be set out in the manner required in a consumer case. All of this is very curious. Continuing warranties are regarded as draconian and disproportionate, are unknown in civil law systems and have received their heaviest criticism in the commercial context. If they are unjust, then they should be jettisoned.

One further important recommendation is the remedy. The concept of automatic termination of risk is an anomaly in English law, and the Law Commissions have recommended its abolition. In its place, a breach of warranty should be regarded in the same way as any other breach of contract: if the breach is sufficiently serious to be repudiatory, the insurers should have the right to treat the policy as terminated as of the date of the breach, whereas if the breach is not repudiatory then they are limited to a claim for damages representing their loss. It will, however, be open to the insurers to include in the policy a cancellation clause which entitles them to terminate even for a

minor breach: such a term would be binding in a business case, but subject to the usual controls on the fairness of terms in consumer contracts. The Law Commissions have provisionally proposed that if future liability is terminated, there should be a pro rata return of premium. One important side-effect of the change in the law will be to bring the law of waiver into line with the general law, so that insurers may waive a breach either by affirmation or by estoppel.

Other terms

One of the potential difficulties with a modification to the law of warranties is that it may result in insurers seeking to achieve the same results by the use of different forms of contract provision, eg, conditions precedent, exclusions and delimitation of risk clauses. The Law Commissions have been timid on this matter. As far as consumer contracts are concerned, no change in the law is recommended, and consumers are to be protected by the Unfair Terms in Consumer Contracts Regulations 1999, although it is not clear that the Law Commissions have fully taken on board the point that those Regulations do not apply to terms which define the risk under an insurance policy. As regards businesses, the control proposed is that a standard policy term (as opposed to a bespoke term) which defines cover in a way that the assured would not reasonably expect (whether it be a warranty, a condition precedent to liability or to cover, an exception or a narrow definition of the risk) would be ineffective insofar as it renders the cover substantially different from what the assured reasonably expected.

The approach to the regulation of other terms might be thought to be patchy and unpredictable. As far as consumer policies are concerned, the 1999 Regulations do not apply to terms which define the main subject matter of the contract, so risk definition is unaffected. As far as business policies are concerned, the reasonable expectations test is uncertain in its application and outcome: the meaning of policy terms is often unclear until tested in the courts, and it is hard to see why there should be an initial and virtually unanswerable question as to their enforceability. What, then, might the Law Commissions have done?

The present commentator suggested to the Law Commissions that the operation of section 54 of the Australian Insurance Contracts Act 1984 repays careful study. The provision deals initially with a policy term which excludes or restricts cover by reason of an act or omission of the assured which could not reasonably be regarded as being capable of causing or contributing to a loss (section 54(1)), a provision which relates primarily to post-loss claims conditions although may also extend to obligations contained in the policy which do not touch the risk. Breach of such a term does not give rise to any right to refuse to pay a claim, but instead the insurers are entitled to damages for any loss suffered by reason of the breach. English law has more or less reached this position where the provision is not expressed as a condition precedent to liability, although if a condition precedent is created then the insurers have – unless the courts can find a way to give effect to their distaste for such clauses – a defence irrespective of loss or prejudice caused by breach. By contrast, if the assured's act or omission is one which could reasonably be regarded as capable of causing or contributing to a loss, then under section 54(2) the insurers are discharged from liability unless: (a) the assured proves that no part of the loss was caused by the act or omission, in which case the claim must be paid (section 54(3)); or (b) the assured can prove that some part of the loss was not caused by that act or omission, he may recover that part (section 54(4)). Thereafter, the insurers have the right to cancel the policy as to the future

(sections 54(6)) and, arguably, to seek damages for any prejudice that they may have suffered by reason of the breach even though it was not the cause of the loss. The general effect of the latter part of section 54 is that insurers cannot refuse to pay a claim unless the assured's act or omission caused the loss, a principle which the Law Commissions have accepted but only if the conduct is framed as the subject of a continuing warranty. It is to be emphasised that section 54 does not prevent insurers from defining the risk or its exclusions by reason of events outside the hands of the assured, and is concerned only with the assured's conduct.

This is not to say that section 54 has been unproblematic. It has given rise to a good deal of litigation, much of it in the context of liability insurance, but it would be relatively straightforward to learn from twenty years of Australian experience and to make express provision for the problem areas. In particular a decision would have to be made as to whether a provision in a claims made liability policy (under which the policy responds to claims made by a third party against the assured in the policy period) which entitles the assured during the currency of the policy to give notice of circumstances which may give rise to a claim and thereby to bring a post-policy claim back into the period of cover, is a provision whose breach can be excused by the statutory equivalent of section 54(1). The New Zealand alternative, found in section 11 of the Insurance Law Reform Act 1977, permits the assured to recover if he can prove that his loss was not caused or contributed to by his breach of a policy term designed to prevent an increased risk of loss. The New Zealand Law Reform Commission regards the provision as too generous to assureds, in that it permits recovery despite blatant breach of contract, and it recommended in 1998 a change so that insurers do not face liability if the assured has broken a term which relates: (a) to the age, identity, qualifications or experience of a person in charge of the insured subject matter; (b) to the geographical area in which he loss must occur; or (c) to a loss which arises when the subject matter is being used for a purpose other than that permitted by the policy.

It is a matter of debate whether causation should be the only test in these cases, whether insurers should be entitled to damages despite a want of causation (Australia) or whether there are certain risk-definition clauses so fundamental that there should be no recovery (New Zealand), in each case on the basis that the policy has been turned into something quite different. What is clear, however, is that laying down different rules depending upon whether the assured's obligation is framed as a warranty, as a delimitation of the risk, as part of an insuring clause, as an exclusion or as a condition precedent is to give precedence to form over substance. The Law Commissions appear to have recognised this very point in their recommendation that there is a need to review the operation of the provisions of sections 42 to 49 of the Marine Insurance Act 1906, which provide for automatic termination of the risk under a voyage policy if the vessel sails from the wrong port, changes voyage or deviates, and prior to consultation on the Second Issues Paper on Warranties were provisionally of the view that an integrated approach was required.

Marine insurance warranties

As noted above, the Law Commissions have provisionally proposed that the causal connection test should also apply to express and implied warranties in marine insurance, although there is a suggestion in the Consultation Paper that the implied marine warranties have outlived their usefulness and could sensibly be abolished.

8 CRITIQUE

In addition to the specific points made earlier in this paper, the present commentator has a number of problems with the Law Commissions' proposals as they stand.

The treatment of businesses

The decision of the Law Commissions to allow the market to govern business policies, but subject to the test that standard terms must match the assured's reasonable expectations, is fraught with difficulty. If rules are unfair, and nobody can sensibly defend the existing English law on warranties, then they should be scrapped. The reasonable expectations test has, in addition, to its own inherent contradiction, three major drawbacks. First, the test is a novel one and its meaning will inevitably give rise to substantial uncertainty: insurance and reinsurance disputes are common enough, even under a regime where the rules are well known. Secondly, the reality of the commercial market is that most assureds, particularly those insuring into the London Market from abroad, place heavy reliance on their brokers to find and negotiate cover. The reasonable expectation of such an assured is to be insured. Thirdly, reform of this type is scarcely designed to attract business from international insurance markets into London. That is not to say that there can never be a case for distinguishing consumer and business policies, and it may be that if there is to be any form of duty of disclosure then the distinction is appropriate. Attention can then be given to how the distinction is to be drawn. The objection is adherence to a doctrinal approach under which consumers are protected but in the business world –within limits – anything goes.

Disclosure: brokers

The Law Commissions appear to have played little regard to the realities of the market and in particular to the manner in which insurance and reinsurance risks are placed in London. Consumer insurance is these days commonly placed direct either online or by telephone, and there is little room for disclosure where such processes are used. Business policies, by contrast, are nearly always placed by brokers, and indeed – as the UK creditors of HIH's film finances cover will testify – often initiated by brokers. The lesson which should be derived from this is that any reform should take account of how insurance is actually placed. The apparent fairness of rules which provide for different remedies based on the state of mind of the assured may be illusory if the assured himself has had little or no personal role in the placement. The root question may indeed be, who should be responsible for the acts and omissions of agents? As the Court of Appeal recently commented in *HIH Casualty and General Insurance Co v JLT Risk Solutions* [2007] EWCA Civ 710 the role of the broker is "notoriously anomalous for its inherent scope for engendering conflict of interest in the otherwise relatively tidy legal world of agency".

To expand upon the point, the consumer proposals (and to some extent the business proposals) rest on the assumption that the assured's own state of mind is the determining factor in the grant of a remedy. In many cases, however, the placement is via an intermediary whose state of mind is crucial to the assured's rights. Where the intermediary is an agent of the insurers, then clearly

his knowledge and intentions cannot be imputed to the assured. By contrast, under the proposals, where the intermediary is a broker, then the broker's fraud or negligence is that of the assured – and in particular it is inconceivable that a broker would not appreciate what was relevant to the insurers – so that the insurers have their usual remedies and the assured must seek to recover what he can from the broker. The same problem exists in Australia: *Permanent Trustee Australia Co Ltd v FAI Insurance Co Ltd* (2003) 197 ALR 364. The allocation of remedies based on state of mind is plainly intended to be for the benefit of assureds, and not for the benefit of insurers: faced with a misrepresentation, it is a matter of fortuity for insurers as to whether or not they have a remedy, and it is not obvious why they should obtain additional rights against an assured whose only error in hindsight was to appoint an inappropriate broker. Furthermore, the justification for giving insurers under business policies the right to avoid for negligence, that it encourages the assured to act more carefully, can scarcely hold good if the relevant negligence is that of the broker. Exactly how is the assured to prevent his broker from acting negligently?

The Law Commission does not recommend any change to the existing position whereby an independent broker is to be treated as the agent of the assured rather than the agent of the insurers, although the rule is to be modified in limited circumstances of section 19 of the 1906 Act. The Law Commissions considered and rejected arguments based on: (a) the deep pocket theory, namely that insurers are more likely than brokers to be able to meet the assured's claim and so insurers should bear liability; (b) the ease of enforcement argument, namely that the assured can simply sue the insurers for the defaults of the broker rather than first suing the insurers, losing and then turning to the broker; (c) the reasonable expectations argument, namely that the assured expects the broker to be acting for insurers; and (d) the market discipline argument, which is that insurers rather than assureds will be aware of broker shortcomings so that inefficient brokers would fall by the wayside if insurers were responsible for their actions.

All were rejected, but arguably wrongly. Surely point (c) is important. Also point (b) is also more important in practice than the Law Commissions appear to have thought. In the consumer context, it is not possible for a complaint to the FOS about avoidance by an insurer to be combined with an alternative complaint against a broker whose default led to the avoidance: if the former fails, a new claim has to be started. In the business world it is all but standard practice for the assured to bring an action against his insurers and to join the brokers, so that if the action against the insurers is dismissed there may be judgment against the brokers and they may be ordered to pay the costs of the entire proceedings, so the ease of enforcement point loses some of its force. However, there are two additional scenarios which are of major practical significance: the policy may contain an arbitration clause, so that if the assured loses against the insurers in arbitration he has to argue his case afresh in litigation against the broker; and there is a strong likelihood that the assured and the insurers will settle the claim for a lesser amount, in which case the assured has to prove in any claim against the broker for the shortfall that the settlement was a reasonable one. These are not insignificant matters. Moreover, if the broker is treated as the agent of the insurers, the duty of disclosure in business insurance will become of limited, if any, significance. It is an essential part of the placing process for the broker to obtain all relevant information from the assured before negotiating with the insurers. That is the case now and will remain so whatever reforms the Law Commissions introduce. If the brokers have asked the right questions, including a sweeping question, the assured will either tell the truth or make false statements. Given that the information-gathering exercise has to take place as between the assured and the broker, it is not immediately apparent why the assured should bear the risk of that

process being improperly replicated as between broker and insurers: there will no longer be any scope for insurers to rely upon non-disclosure by the broker where he has been given the true information by the assured.

A further thought: given the problems surrounding the meaning of section 19, and its effect of casting the burden of the broker's market knowledge on the assured, would the world be a worse place if section 19 was repealed in its entirety?

9 REFORM OF THE LAW OF INSURABLE INTEREST

The requirements for insurable interest

There is no single law which requires an insurance policy to be supported by insurable interest. The principles have developed piecemeal over some 300 years, and are derived both from Acts of Parliament specifically designed to deal with particular problems and from general principles of law relating to insurance and to gambling. Distinctions are to be drawn between four classes of policy.

Life insurance, which is non-indemnity insurance in that the assured is entitled to recover the sum insured, is regulated by the Life Assurance Act 1774. This Act requires the policyholder to have an insurable interest in the life assured at the date of the policy, but not at any point thereafter (so held in *Dalby v India and London Life Assurance Company* (1854) 15 CB 365): this means that the policy can be assigned to a person without interest and that it does not lapse if the policyholder's interest itself lapses. It is said that this confers upon life insurance its investment properties, in that the contract has a commercial value in its own right. The 1774 Act is nevertheless a curiosity: it does not define insurable interest, a matter which has been left to the courts; it renders a policy without interest not just void but also illegal, so the policyholder cannot recover premiums paid in pursuance of it (s 1); the names of all interested parties have to be inserted in the policy at the outset (s 2), which is problematic where the policy covers a class of persons; and the amount recoverable under the policy is restricted to the value of the policyholder's interest at the date of the policy (s 3), so that there is curious indemnity principle built into the legislation.

Indemnity, insurance, including property and liability insurance under which the assured is entitled to recover only what he has lost, is not regulated by any legislation at all. The Gaming Act 1845, s 18, rendered null and void any contract made by way of gambling or wagering, and this section was thought to affect any indemnity policy taken out by an assured who had no interest or expectation of acquiring an interest in the insured subject matter. However, the repeal of s 18 by the Gambling Act 2005 has now removed this prohibition, with the result that an indemnity policy is valid even though it is made by way of gaming or wagering. However, because the policy is one of indemnity, the assured is only able to recover under the policy on proof of loss, so if the assured has no interest in the lost subject matter he is unable to recover at all. In summary, anyone can insure under an indemnity policy whether or not he is interested in the subject matter, but recovery will not be possible in the absence of proof of loss.

Non-indemnity insurance in the form of a valued policy on property or some other risk (other than life or a marine adventure) is treated somewhat differently. A valued policy fixes the value of the insured subject matter from the outset, so that the assured is entitled to recover that sum from the insurers in the event of a loss. Once again, as is the case with indemnity insurance, the effect of the Gambling Act 2005 is that the assured need not possess an insurable interest at the date of the policy. However, it would seem that the fact that the policy is valued does not remove the need for the assured to show insurable interest at the date of the loss: the difference is that if the assured can show an insurable interest then he is entitled to recover the agreed value even though that may be vastly in excess of his interest and the actual value. The valued nature of the policy does not remove the need for insurable interest, it only removes arguments about how much is payable where interest is shown.

Marine insurance has its own rules. These date back to 1745, but were codified in the Marine Insurance Act 1906. Section 4 outlaws any policy made by way of gaming or wagering, which means that a policy taken out without interest or with no expectation of acquiring interest, or one which is framed in terms that the insurers will pay interest or no interest (ppi – "policy proof of interest") is void. There is a dispute as to whether the Gambling Act 2005 has impliedly repealed s 4 of the 1906 Act, although it should be said that the majority view (with which the present commentator disagrees) is that s 4 has been left unaffected. Section 6 restates the indemnity principle that the assured must be interested at the date of the loss, although it has been decided that if the policy is valued then the assured is entitled to recover the full agreed valuation as long as he has some interest even if not to the agreed amount. Insurable interest is defined in general terms by s 5, and there are specific illustrations of insurable interest in ss 7 to 14 of the Act. There is a further curiosity in respect of marine insurance, in the form of the Marine Insurance (Gambling Policies) Act 1909 which makes it a criminal offence for a person to effect a marine policy by way of gaming or wagering. This odd piece of legislation appears never have been used to mount a prosecution.

What is insurable interest?

There is no all-embracing statutory definition of insurable interest. Section 5 of the Marine Insurance Act 1906, which is derived from the judgment of Lord Eldon in *Lucena v Craufurd* (1806) 2 Bos & PNR 269, states that an insurable interest is possessed by a person who stands in a legal or equitable relation to a marine adventure or to any property at risk, in consequence of which he may benefit by the safety or due arrival of insurable property, or may be prejudiced by its loss. This definition has been applied by the courts to the various forms of insurance, but with adaptations to take account of the class of insurance in question. The presently accepted definition focuses upon pecuniary interest. In recent years, as new products and new methods of doing business have arisen, the courts have tended to broaden the definition of insurable interest. In the most recent case, *Feasey v Sun Life Assurance Co of Canada* [2003] Lloyd's Rep IR 637, the Court of Appeal adopted an expansive approach to insurable interest, arguably to the extent of dispensing with the pecuniary interest requirement entirely.

The need for insurable interest

The law is, as has been seen, confusing and technical. The Law Commissions' initial question is whether there is any need for a doctrine of insurable interest. The two stated purposes of insurable interest – to produce a definition of insurance, and to prevent gambling – are considered.

On the question of definition, the Law Commissions have set out their provisional view that it is possible to define insurance other than in terms of insurable interest. The Issues Paper identifies the various purposes for which insurance has to be defined – regulatory, common law, tax – and concludes that insurable interest is not a key factor for any of those purposes. The Financial Services Authority, in a policy statement issued in 2002, has stated that in defining insurance for regulatory purposes insurable interest is not a defining feature of insurance and that more important factors were the assumption of risk, premium representing the risk transferred and the obligations of the parties (eg, utmost good faith). Similarly, common law and tax legislation rely upon those factors rather than insurable interest.

On the question of gambling, it is clearly the case that the development of insurable interest rested upon fear of the harmful consequences of gambling both for the reputation of the insurance industry and for society as a whole. There was a related fear that a person without interest might destroy the insured subject matter or murder the life assured for the insurance proceeds. The Law Commissions have point out that gambling is now widely accepted, particularly since the passing of the Gambling Act 2005. Further, while there is a risk of destruction or murder, such risks exist even where there is insurable interest, as is illustrated by the various instances of murder for insurance within marriage.

The proposed regime: life assurance

As regards life assurance, the Law Commissions are of the view that the law is unsatisfactory in at least three respects. First, the definition of insurable interest is too restrictive: there is a doubt whether the law permits an employer to back contractual in-service death benefits by a group life policy, the fear being that the employer may insure only for a sum which represents his own interest in the employee's life, ie, to the extent of the employee's notice period; and a travel policy taken out by parents which includes insurance on the lives of their children may not be required to pay on the death of a child because a parent does not have insurable interest; and cohabitees (unless married or in a civil partnership) may not be able to insure each other's lives. It may be possible to overcome these matters by resort to trust and agency devices, but that is unduly complex.

Secondly, the requirements of the 1774 Act itself are unduly technical and may inhibit ordinary commercial activities. Thus the requirement for insurable interest on inception could mean that a company cannot insure the life of a key employee of another company which it is seeking to buy. The requirement for the insertion of names of interested parties in s 2 adds nothing to the insurable interest requirement. The limit of recovery in s 3 prevents proper insurance on interest which accrues on a debt and it also prevents an employer from insuring a key employee for anything beyond the value of that employee to the enterprise at the time the policy was taken out. The Law Commissions have also pointed out that the 1774 Act can in any event be sidestepped by the simple device of a person taking out an own-life policy, the law recognising an unlimited insurable interest here so that the policy can be for any amount, and then assigning the policy to a

third party who would himself have been precluded from insuring. The illegality sanction for want of insurable interest is draconian, particularly because the fault that the policy was taken out in that form may not be that of the assured at all. The Law Commissions have thus said that "Insurable interest has therefore become a complex provision that trips up the unwary and those without proper legal advice."

Thirdly, because insurable interest is not required at the death of the life assured, assignees without interest may benefit, and those whose interest has been lost or which has diminished may also recover. This runs contrary to the stated objective of the 1774 Act to eliminate gambling from life insurance.

The Law Commissions have nevertheless provisionally recommended that there should continue to be a requirement for insurable interest at the inception of life policies, for the following reasons: (a) people instinctively dislike the possibility that a stranger may insure their lives, and a policy could be a threat; (b) there should be a reason for the taking out of life insurance. Given, therefore, that insurable interest is to be required, the question then becomes, what is insurable interest for these purposes? The Law Commissions have tentatively proposed that a policy should be permitted in three situations.

First, the Law Commissions have further tentatively proposed that the definition of insurable interest should be extended to remove certain anomalies: natural love and affection should be a ground for insurable interest, so that policies should be permitted on cohabitees, on adult children by parents and on parents or guardians by dependants. The Law Commissions are uncertain whether other relationships – parents on infant children, cohabitees, siblings, grandparents/grandchildren – are sufficiently close to justify automatic insurable interest. Where there is insurable interest, the Law Commission is provisionally of the view that is should be permissible to insure for an unlimited amount

Secondly, as far as pure pecuniary interests are concerned, key employee policies and the like, the Law Commissions are provisionally of the view that an expectation of pecuniary loss should support an insurable interest so that the amount of insurance is not tied to the assured's pecuniary interest at inception, but subject to the requirement that the assured and the insurers are satisfied that the expectation of loss is reasonable.

Thirdly, although love and affection, and pecuniary interest, remain the touchstones for insurable interest, the Law Commissions are also recommending that even if these interests do not exist it should be permissible for a policyholder to take out a policy on the life of another if that other has consented to the policy. It is to be emphasised that the proposal is not to require consent where insurable interest exists, but rather to allow insurance where there is no insurable interest, consent acting as a substitute.

Other issues in relation to life insurance are as follows. (1) The Law Commissions are considering whether special rules are required to allow employers to take out group life policies for employees, insuring for sums in excess of the employers' insurable interest and recognising that the policies are for the benefit of employees. (2) If a policy is taken out without interest or consent, the policy should be void and not illegal, so that where appropriate the premiums can be refunded to the policyholder. (3) Views are sought on whether life insurers should be under a

duty to check that the policyholder has a valid insurable interest. (4) Views are also sought on the fate of a life policy when the insurable interest of the policy holder lapses, eg, on divorce, the termination of employment or the repayment of a debt. The Law Commissions has noted suggestions whereby the assured would be given the option of taking over the policy on lapse of interest, thereby converting it into an own-life policy, or having the right to withhold consent to an assignment, but has not adopted them. (5) Section 2 of the 1774 Act, requiring the names of all interested parties to be inserted in the policy, should be repealed.

The proposed regime: indemnity insurance

The Law Commissions have pointed out a number of inconsistencies and uncertainties in the law. For example, it is not clear whether an insurance policy can dispense with the indemnity principle and allow the assured to recover whether or not there is an interest at the time of the loss. One possible example of the point given by the Law Commissions is the operation of a follow the settlements clause in reinsurance, where it suffices for the reinsured to prove that it acted in a bona fide and businesslike fashion in settling with the assured even though there may not in fact or law have been actual liability to the assured. The decision in *Feasey* has also created some difficulty in determining exactly what an insurable interest might be. Other issues include outstanding doubts (misplaced in the view of the present author) that the Life Assurance Act 1774 continues to apply to policies on land and buildings), the scope of the principle that a bailee may insure for the full value of property within his possession and the fact that the requirement for insurable interest at the date of the policy has apparently been abolished by accident with the repeal of the Gaming Act 1845, s 18, by the Gambling Act 2005.

As far as marine insurance is concerned, the key issue is whether the Gambling Act 2005 has dispensed with the need for an actual or potential interest at the date of the policy. The Law Commissions have also queried the need for criminal penalties in the 1909 Act.

The Law Commissions' position is as follows. First, the provisional conclusion is that insurable interest should not be required at the inception of the policy. The balance is between on the one hand the threat of destruction of property by a person not interested in it and the need for a good reason for insurance, and on the other hand the need for commercial certainty. The Law Commissions are of the view that insurable interest at inception adds nothing to the indemnity principle at the date of loss, which appears to represent the present law following the Gambling Act 2005. Secondly, given that there will remain a requirement for the assured to prove loss at the date of the occurrence of the insured peril, the Law Commissions have asked whether there should be a legal requirement on insurers to check that the assured has an expectation or a chance of loss at the outset so that the policy is not worthless. Secondly, the Law Commission is proposing the repeal of the redundant 1909 Act, and removing from the statute book the principle that taking out a marine policy by way of wagering or gaming is a criminal offence. Thirdly, again as regards marine insurance, the Law Commissions are suggesting that the requirement that the names of interested parties are to be inserted should be repealed.

(End)

(*Rob Merkin* : *Southampton University, Barlow Lyde & Gilbert LLP)*