THE WAY FORWARD FOR UK INSURANCE LAW (Part II)

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(Continued from Part I)

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?

(To be continued…)

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(For full version we refer you to the full article on our website : www.seatransport.org)